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No. ~~1054~~ .....

IN THE

Supreme Court of the United States

OCTOBER TERM, 1966

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CONTINENTAL OIL COMPANY and
MIDHURST OIL CORPORATION,

Petitioners,

v.

FEDERAL POWER COMMISSION,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

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Petitioners Continental Oil Company and Midhurst Oil Corporation respectfully pray that a Writ of Certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Tenth Circuit entered on January 20, 1967, in *Skelly Oil Company, et al., Petitioners,* v. *Federal Power Commission, Respondent* (10th Circuit Nos. 8385, *et al.*), affirming in part Opinion Nos. 468 and 468-A of Respondent Federal Power Commission, issued in the Permian Basin Area Rate Proceeding, FPC Docket AR61-1, *et al.*

OPINIONS BELOW

The opinion of the Court of Appeals for the Tenth Circuit which is not yet reported is printed as Appendix A hereto. Opinion Nos. 468 and 468-A and accompanying

modifying and amending orders of the Federal Power Commission (R. 516d-826d, 1105d-1132d, 1154d-1155d, 1156d-1157d) are reported at 34 FPC 159, 34 FPC 1068, 34 FPC 1198 and 34 FPC 1286. The judgment of the Court of Appeals is printed as Appendix B.

JURISDICTION

The opinion and judgment of the Court of Appeals were entered on January 20, 1967. This petition is timely filed and the jurisdiction of this Court is invoked under 28 USC § 2101 and Rule 19 of the Rules of this Court.

QUESTIONS PRESENTED

1. Whether the regulatory method adopted by the Federal Power Commission for area rate regulation of independent producers must be compatible with the basic characteristics of the gas producing industry.

2. Whether the Commission can lawfully and equitably impose a regulatory method for determining area rates for independent producers which employs a dual system of pricing providing different prices for identical gas based merely on the time at which gas sales contracts were executed, and the kind of well from which the gas is produced.

3. Whether the Commission can lawfully and equitably adopt a regulatory method for determining independent producer area rates which is almost exclusively based upon utilization of composite *average* industry costs to determine industry revenue requirements and *ceiling* prices.

4. Whether the Commission can lawfully and equitably require producers in the Permian Basin Area to refund

amounts collected in excess of the area ceiling rates under given contracts, without permitting the producers as a group to balance revenues under those contracts affording above area ceiling rates with the deficiencies in revenues under contracts providing below area ceiling rates in order to determine as a prerequisite of any refunds whether there is an overall deficiency in group revenues under all contracts compared to the group costs upon which area ceiling rates are based.

5. Whether the Commission can lawfully and equitably impose a moratorium on rate increases and filings above the ceilings until January 1, 1968.

6. Whether the Court of Appeals can decline to exercise its review function under § 19(b) of the Natural Gas Act [15 USC § 717r(b)] by expressly refusing to consider in any way the Commission's cost method of determining area cost and rates, including selection and adequacy of data sources, methods of cost allocations and the cost results.

7. Whether the Commission could lawfully and equitably establish the rates determined in the face of the overwhelming preponderance of the economic evidence proving the need for higher rates.

STATUTES INVOLVED

The Natural Gas Act, 52 Stat. 821 *ff.*, 15 USC § 717-717w, provides in pertinent part:

RATES AND CHARGES; SCHEDULES; SUSPENSION OF NEW RATES

SEC. 4. (a) All rates and charges made, demanded, or received by any natural-gas company for or in connec-

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PETITION FOR A WRIT OF CERTIORARI

tion with the transportation or sale of natural gas subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges, shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful.

(b) No natural-gas company shall, with respect to any transportation or sale of natural gas subject to the jurisdiction of the Commission, (1) make or grant any undue preference or advantage to any person or subject any person to any undue prejudice or disadvantage, or (2) maintain any unreasonable difference in rates, charges, service, facilities, or in any other respect, either as between localities or as between classes of service.

(c) Under such rules and regulations as the Commission may prescribe, every natural-gas company shall file with the Commission, within such time (not less than sixty days from the date this act takes effect) and in such form as the Commission may designate, and shall keep open in convenient form and place for public inspection, schedules showing all rates and charges for any transportation or sale subject to the jurisdiction of the Commission, and the classifications, practices, and regulations affecting such rates and charges, together with all contracts which in any manner affect or relate to such rates, charges, classifications, and services.

(d) Unless the Commission otherwise orders, no change shall be made by any natural-gas company in any such rate, charge, classification, or service, or in any rule, regulations, or contract relating thereto, except after thirty days' notice to the Commission and to the public. Such notice shall be given by filing with the Commission and keeping open for public inspection new schedules stating plainly the change

or changes to be made in the schedule or schedules then in force and the time when the change or changes will go into effect. The Commission, for good cause shown, may allow changes to take effect without requiring the thirty days' notice herein provided for by an order specifying the changes so to be made and the time when they shall take effect and the manner in which they shall be filed and published.

(e) Whenever any such new schedule is filed the Commission shall have authority, either upon complaint of any State, municipality, State commission, or gas distributing company or upon its own initiative without complaint, at once, and if it so orders, without answer or formal pleading by the natural-gas company, but upon reasonable notice, to enter upon a hearing concerning the lawfulness of such rate, charge, classification, or service; and, pending such hearing and the decision thereon, the Commission, upon filing with such schedules and delivering to the natural-gas company affected thereby a statement in writing of its reasons for such suspension, may suspend the operation of such schedule and defer the use of such rate, charge, classification, or service, but not for a longer period than five months beyond the time it would otherwise go into effect; and after full hearings, either completed before or after the rate, charge, classification, or service goes into effect, the Commission may make such orders with reference thereto as would be proper in a proceeding initiated after it had become effective. If the proceeding has not been concluded and an order made at the expiration of the suspension period, on motion of the natural-gas company making the filing, the proposed change of rate, charge, classification, or service shall go into effect. Where increased rates or charges are thus made effective, the Commission may, by order, require the natural-gas company to furnish a bond,

to be approved by the Commission, to refund any amounts ordered by the Commission, to keep accurate accounts in detail of all amounts received by reason of such increase, specifying by whom and in whose behalf such amounts were paid, and, upon completion of the hearing and decision, to order such natural-gas company to refund, with interest, the portion of such increased rates or charges by its decision found not justified. At any hearing involving a rate or charge sought to be increased, the burden of proof to show that the increased rate or charge is just and reasonable shall be upon the natural-gas company, and the Commission shall give to the hearing and decision of such questions preference over other questions pending before it and decide the same as speedily as possible. [52 Stat. 822 (1938); 76 Stat. 72 (1962); 15 U.S.C. § 717c]

FIXING RATE AND CHARGES; DETERMINATION OF COST OF PRODUCTION OR TRANSPORTATION

SEC. 5. (a) Whenever the Commission, after a hearing had upon its own motion or upon complaint of any State, municipality, State commission, or gas distributing company, shall find that any rate, charge, or classification demanded, observed, charged, or collected by any natural-gas company in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order: *Provided, however,* That the Commission shall have no power to order any increase in any rate contained in the currently

the Commission, unless such increase is in accordance with a new schedule filed by such natural-gas company; but the Commission may order a decrease where existing rates are unjust, unduly discriminatory, preferential, otherwise ineffective schedule of such natural-gas company on file with lawful, or are not the lowest reasonable rates.

(b) The Commission upon its own motion, or upon the request of any State commission, whenever it can do so without prejudice to the efficient and proper conduct of its affairs, may investigate and determine the cost of the production or transportation of natural gas by a natural-gas company in cases where the Commission has no authority to establish a rate governing the transportation or sale of such natural gas. [52 Stat. 823 (1938); 15 U. S. C. § 717d].

EXTENSION OF FACILITIES; ABANDONMENT OF SERVICE

SEC. 7. (a) Whenever the Commission, after notice and opportunity for hearing, finds such action necessary or desirable in the public interest, it may by order direct a natural-gas company to extend or improve its transportation facilities, to establish physical connection of its transportation facilities with the facilities of, and sell natural gas to, any person or municipality engaged or legally authorized to engage in the local distribution of natural or artificial gas to the public, and for such purpose to extend its transportation facilities to communities immediately adjacent to such facilities or to territory served by such natural-gas company, if the Commission finds that no undue burden will be placed upon such natural-gas company thereby: *Provided,* That the Commission shall have no authority to compel the enlargement of transportation facilities for such purposes, or to compel such natural-gas company to establish physical connection or sell natural gas

when to do so would impair its ability to render adequate service to its customers. [52 Stat. 824 (1938); 15 U. S. C. § 717f (a)]

(b) No natural-gas company shall abandon all or any portion of its facilities subject to the jurisdiction of the Commission, or any service rendered by means of such facilities, without the permission and approval of the Commission first had and obtained, after due hearing, and a finding by the Commission that the available supply of natural gas is depleted to the extent that the continuance of service is unwarranted, or that the present or future public convenience or necessity permit such abandonment. [52 Stat. 824 (1938); 15 U. S. C. § 717f (b)]

(c) No natural-gas company or person which will be a natural-gas company upon completion of any proposed construction or extension shall engage in the transportation or sale of natural gas, subject to the jurisdiction of the Commission, or undertake the construction or extension of any facilities therefor, or acquire or operate any such facilities or extensions thereof, unless there is in force with respect to such natural-gas company a certificate of public convenience and necessity issued by the Commission authorizing such acts or operations: *Provided, however,* That if any such natural-gas company or predecessor in interest was bona fide engaged in transportation or sale of natural gas, subject to the jurisdiction of the Commission, on the effective date of this amendatory Act, over the route or routes or within the area for which application is made and has so operated since that time, the Commission shall issue such certificate without requiring further proof that public convenience and necessity will be served by such operation, and without further proceedings, if application for such certificate is made to the Commission within ninety days after the effective date of this amendatory Act. Pend-

ing the determination of any such application, the continuance of such operation shall be lawful.

In all other cases the Commission shall set the matter for hearing and shall give such reasonable notice of the hearing thereon to all interested persons as in its judgment may be necessary under rules and regulations to be prescribed by the Commission; and the application shall be decided in accordance with the procedure provided in subsection (e) of this section and such certificate shall be issued or denied accordingly: *Provided, however,* That the Commission may issue a temporary certificate in cases of emergency, to assure maintenance of adequate service or to serve particular customers, without notice or hearing pending the determination of an application for a certificate, and may by regulation exempt from the requirements of this section temporary acts or operations for which the issuance of a certificate will not be required in the public interest. [52 Stat. 825 (1938), as amended, 56 Stat. 83 (1942); 15 U. S. C. § 717f (c)]

(d) Application for certificates shall be made in writing to the Commission, be verified under oath, and shall be in such form, contain such information, and notice thereof shall be served upon such interested parties and in such manner as the Commission shall, by regulation, require. [56 Stat. 84 (1942); 15 U. S. C. § 717f (d)]

(e) Except in the cases governed by the provisos contained in subsection (c) of this section, a certificate shall be issued to any qualified applicant therefor, authorizing the whole or any part of the operation, sale, service, construction, extension, or acquisition covered by the application, if it is found that the applicant is able and willing properly to do the acts and to perform the service proposed and to conform to the provisions of the Act and the require-

ments, rules, and regulations of the Commission thereunder, and that the proposed service, sale, operation, construction, extension, or acquisition, to the extent authorized by the certificate is or will be required by the present or future public convenience and necessity; otherwise such application shall be denied. The Commissson shall have the power to attach to the issuance of the certificate and to the exercise of the rights granted thereunder such reasonable terms and conditions as the public convenience and necessity may require. [56 Stat. 84 (1942); 15 U. S. C. § 717f (e)]

(f) The Commission, after a hearing had upon its own motion or upon application, may determine the service area to which each authorization under this section is to be limited. Within such service area as determined by the Commission a natural-gas company may enlarge or extend its facilities for the purpose of supplying increased market demands in such service area without further authorization. [56 Stat. 84 (1942); 15 U. S. C. § 717f (f)]

(g) Nothing contained in this section shall be construed as a limitation upon the power of the Commission to grant certificates of public convenience and necessity for service of an area already being served by another natural-gas company. [56 Stat. 84 (1942); 15 U. S. C. § 717f (g)]

(h) When any holder of a certificate of public convenience and necessity cannot acquire by contract, or is unable to agree with the owner of property to the compensation to be paid for, the necessary right-of-way to construct, operate, and maintain a pipe line or pipe lines for the transportation of natural gas, and the necessary land or other property, in addition to right-of-way, for the location of compressor stations, pressure apparatus, or other stations or equipment necessary to the proper operation of such pipe line or pipe lines, it may acquire the same by the

exercise of the right of eminent domain in the district court of the United States for the district in which such property may be located, or in the State courts. The practice and procedure in any action or proceeding for that purpose in the district court of the United States shall conform as nearly as may be with the practice and procedure in similar action or proceeding in the courts of the State where the property is situated: *Provided,* That the United States district courts shall only have jurisdiction of cases when the amount claimed by the owner of the property to be condemned exceeds $3,000. [61 Stat. 459 (1947); 15 U. S. C. § 717f (h)]

STATEMENT

In *Wisconsin* v. *Federal Power Commission,* 373 U.S. 294 (1963), this Court was confronted with the advent of the Commission's area ratemaking approach to producer regulation. This Court there acknowledged at 373 U.S. 309-310 the avowed purpose of producer area rate regulation:

> ". . . The Commission has stated in its opinion in this proceeding [the remanded Phillips 5(a) proceeding there before the Court] that the goal [of the area rate method] is to have rates based on the 'reasonable financial requirements of the industry' in each production area, 24 FPC at 547 . . .
>
> ". . . We share the Commission's hopes that the area approach may prove to be the ultimate solution."

This is the case in which this Court is first asked to decide whether those hopes have been realized.

The area involved is the Permian Basin Area located in West Texas and Southeastern New Mexico, comprising

one of the largest and most important natural gas producing areas in the nation.

Petitioners are independent producers of natural gas engaged in sales of natural gas subject to Commission jurisdiction under the Natural Gas Act in fields in the Permian Basin Area, and were respondents in the Permian Basin Area Rate Proceeding. In this first area rate proceeding, the Commission issued Opinion 468 and implementing orders on August 5, 1965, and thereafter by Opinion 468-A issued October 4, 1965, denied rehearing sought by these Petitioners and others.

The Commission held that regulation of independent producers under the Natural Gas Act should be on an area basis; and purported to determine just and reasonable rates within the area for all producers. In so doing, the Commission established two ceiling rates, one for "new" gas well gas and one for all other gas denominated "flowing gas" or "old gas". The 16.5¢ per Mcf ceiling for new gas well gas was based upon a current cost computation utilizing data from various statistical sources. The 14.5¢ ceiling for flowing gas was based upon a historical (1960 test year) rate base cost of service computation employing cost and revenue data obtained from questionnaires from selected producers. New gas well gas was defined as all gas well gas committed to contract January 1, 1961 or later and all residue gas after processing such gas well gas. Flowing gas was defined as all other gas, meaning all oil well gas (casinghead gas), all gas well gas committed to contract prior to January 1, 1961, and all residue gas after processing of either.

The separately established rates for new and old gas and for types of gas were made applicable only to gas conforming to certain "pipeline quality" specifications. These quality standards related to Btu heating value, pressure and content of other substances such as water, hydrogen

sulphide, sulphur and carbon dioxide commonly found in natural gas.

From the applicable ceiling rates, downward adjustments were provided for any gas which did not conform to the quality standards specified by the Commission. Most gas in the Permian Basin is below pipeline quality as specified. In the case of Btu content, a proportional downward adjustment for gas below 1,000 Btu per cubic foot and upward adjustment for gas above 1,050 Btu per cubic foot was ordered. The "applicable area rate" for each sale of gas in the Permian Basin Area was defined to be the ceiling or base area rate, with reference to the date of contract and type of gas, as adjusted for quality deviations from the Commission-prescribed standards.

The Commission also ordered a 2½ year moratorium against filing for any rate increases above the applicable area rate.

Refunds of amounts collected prior to the effective date of the Commission's opinion in excess of the applicable area rates where the excess had been suspended under Section 4 of the Act, plus interest, were ordered.

Petitioners and other producers duly filed timely petitions for review of Opinion 468 and Opinion 468-A before the United States Court of Appeals for the Tenth Circuit. The Court of Appeals issued its decision below on January 20, 1967, in the cases before it seeking review of the Commission's Permian Basin area rate decision. While the Tenth Circuit affirmed the basic regulatory method employed by the Commission in determining and regulating area rates, it remanded certain matters to the Commission for further proceedings. The main defect the court below found in the Commission's opinion related to the regulatory standard employed by the Commission. The

Commission held there was a "fair relationship" between the consumer costs of Permian Basin gas at the rates established and the "revenue requirements" of the producers. According to the court below, it was error to depart from the "end result" test or standard first enunciated in *Federal Power Commission* v. *Hope Natural Gas Company,* 320 U.S. 591 (1944), whereby it can be demonstrated that established rates will return to the regulated producer its revenue requirements or costs. In this case the Commission could not employ the end result test because there was in the record no evidence on the extent of quality deviations or the cost of correcting them. Therefore, since neither the producers' whole cost nor actual revenues could be determined, the end result test could not be made.

While Petitioners do not object to the regulation of producer rates on an area basis *per se,* Petitioners do vigorously object to the affirmance by the court below of the methods employed by the Commission in determining and regulating area rates, and the rates established, in the following particulars: (1) approval of the Commission's refusal to relate the regulatory method to the basic characteristics of the industry; (2) approval of the dual pricing system; (3) approval of the Commission's determination of area rates for independent producers on the basis of selective composite industry computed average costs; (4) approval of the Commission's refund order without regard to industry or individual producer revenue deficiencies; (5) approval of the imposition of a moratorium on rate increases; (6) the abandonment by the court below of its review function by refusing to consider the cost evidence and costing methods employed in determining the area rates; (7) the approval in principle of the rate levels established. In these and other essential respects the Court of Appeals rejected Petitioners' contentions that the Commis-

sion's regulatory method must conform to the essential economic characteristics of the natural gas producing industry and must perform the regulatory objectives of assuring a continuing adequate supply of gas at just and reasonable rates.

REASONS FOR GRANTING THE WRIT

The opinion of the court below presents substantial, novel and important questions of first impression as to the proper basis for regulation of independent producers under the Natural Gas Act. These are stated in the foregoing "Questions Presented" and given focus in the foregoing "Statement". At the root, this Court must decide the fundamental question of whether producer rate regulation is to be limited to narrow utility type cost of service computations or whether the method of producer rate regulation should comport with the basic characteristics of the industry which is to be regulated.

While recognizing that cost based regulation is contrary to the economic facts of the industry (Appendix p. 48a), the court below has brushed aside without adequate basis Petitioners' arguments that the Commission's entire regulatory method is ill-suited and unworkable when applied to producers even if it is a suitable method for regulating public utilities. The opinion of the court below does not show how the basic requirement of sound regulation — that a regulatory method must be suited to the characteristics of the industry to be regulated — has been met by the method employed in Opinion Nos. 468 and 468-A. See *Wisconsin* v. *Federal Power Commission*, 373 U.S. 294, 308-310 (1963). The remand below did not cure the pervading defect of the Commission's regulatory approach which would fetter the gas producing industry with a wholly ill-fitted mode of regulation not framed or appropriate to effectuate the basic regulatory purpose under the Natural

Gas Act of assuring consumers an adequate supply of gas at just and reasonable prices.

The court below did not assign as error the Commission's unsupported findings or failure to make necessary findings respecting competition, economic conditions in the industry, supply, demand and incentives fundamental to fulfilling the basic regulatory purpose. These errors of the court below as to basic regulatory concepts and methods are in conflict with the spirit and philosophy of this Court's decision approving the Commission's initial efforts in experimenting with producer area rate regulation, as stated in *Wisconsin* v. *Federal Power Commission, supra,* at 310, wherein the Court cited with approval the prior opinions and analyses of Mr. Justice Jackson in *Federal Power Commission* v. *Hope Natural Gas Company,* 320 U.S. 591, 628-660, and in *Colorado Interstate Gas Company* v. *Federal Power Commission,* 324 U.S. 581, 608-615. These errors are even in conflict with the Commission's Opinion No. 338, 24 FPC 537 (1960)* where the Commission recognized that producer regulation could not be based on a cost of service approach, stating at 24 FPC 542-544:

> "Experience of the Commission in this case, as well as in many other producer rate cases during the last five years, has shown, beyond any doubt, that the traditional original cost, prudent investment rate base method of regulating utilities is not a sensible, or even a workable method of fixing the rates of independent producers of natural gas. . . .
>
> "Producers of natural gas cannot, by any stretch of the imagination, be properly classified as traditional public utilities. Justice Harlan, dissenting in the recent case of *Sunray Oil Co.* v. *F.P.C.,* 364 U.S. 137 at p. 160, characterized the difference as follows:

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* *Phillips Petroleum Company,* affirmed in *Wisconsin* v. *Federal Power Commission, supra.*

"* * * A pipeline performs a service akin to those traditionally performed by public utilities. The independent producer, on the other hand, is unique among the objects of public-utility regulation because it is not engaged in rendering a service to the public in the conventional sense of that concept, but rather simply in selling a commodity which it owns * * *"

"We are not dealing with a service requiring certain equipment at known costs. We are dealing in many instances with one of two commodities produced with the same equipment and processed to varying degrees prior to sale. The price of the second commodity, oil, is unregulated, as is that part of the gas, which is sold in intrastate commerce or other transactions not subject to our jurisdiction, as well as the products which are extracted prior to shipment. Thus we are faced with the extremely difficult problem of allocating costs between the regulated and unregulated products . . .

". . . In the case of the producer, the amounts involved in the allocations of costs are major in size and extremely difficult to make. The result is that a producer actually could become bankrupt, or could make enormous profits, depending merely on the methods of allocation used . . .

"Further experience may enable us to refine and improve our allocation methods, but it is clear that the calculation of the unit cost of gas is, and will be an inexact, complex, unsatisfactory, and time consuming process, fraught with controversy. The result finally reached may give the illusion of accuracy since mathematical processes are involved, and a definite price per Mcf is the final result. But such a result must be tested against the realities of the market place. Thus, prices calculated solely on the cost rate base principle cannot be accepted if they are higher than a buyer will pay, or lower than a seller will accept.

"When an unrealistic result is reached, the formulae for allocations must be changed, in order to bring about a reasonable result. The allocation methods then be-

come a means of supporting a result already arrived at, rather than a means of arriving at a result which was previously unknown."

and at 24 FPC 547:

"From the foregoing, it follows that effective regulation of the price of natural gas must be on some more manageable plan than the rate base method. Thus it is clear that the better method would be to establish fair prices for the gas itself and not for each individual producer. . . . It appears that the ultimate solution to producer regulation will be in the determination of fair prices for gas, based on reasonable financial requirements of the industry and not on the particular rate base and expenses of each natural gas company. . . .

"Our ultimate objectives will be to set prices in all producing areas which will be adequate to maintain the gas supplies needed by the consumers of the nation, but at prices that are no higher than are necessary to accomplish that purpose."

Rejecting a cost of service method of producer regulation in favor of a better suited method, the Commission continued at 24 FPC 548:

"Nowhere in the Natural Gas Act is there as much as one word which indicates that this Commission must use a rate base in determining just and reasonable rates. The correct construction of the Natural Gas Act on this question, both as a legal and as a practical matter has been made by the Court of Appeals of the Fifth Circuit in *Forest Oil Corporation* v. *F.P.C.*, 263 F. 2d 622 (1959), wherein the Court said:

" 'We do not think that either the Commission or the petitioner should be baffled or handicapped in this new field of regulation by any formulas by whatever name they are known. . . .'

"In dealing with competitive industries such agencies as the Interstate Commerce Commission have found it

> best to work out regulatory principles based on numerous other standards and criteria. Producer regulation will have to be based on similar considerations. As Justice Jackson . . . concluded in the *Hope* case, *supra,* at page 650:
>
> "'* * * If natural gas rates are intelligently to be regulated we must fit our legal principles to the economy of the industry and not try to fit the industry to our books * * *.'"

Another essential question which must be resolved is the validity of the Commission's artificially contrived dual price system, which disregards the economic truth that natural gas is, indeed, one commodity having one value to consumers. As this Court has recognized, producer area ratemaking involves "regulating the price of a commodity," natural gas. *Wisconsin* v. *Federal Power Commission, supra,* at p. 310. The narrowly conceived dual price system, compounded by separate pricing of gas by types and vintages without regard to economic value, threatens to perpetuate a harsh, inequitable and discriminatory pattern of pricing which will prove harmful to the public interest in discouraging and restricting needed exploration and production of natural gas.

Moreover, both the Commission's Permian Basin area opinion and the opinion of the Court of Appeals contain inconsistencies which must be resolved by this Court. The Commission's regulatory method, which fixes *ceiling* prices based on *average* costs, is an irrational method which cannot permit full recovery of costs by the industry, as recognized by the Court of Appeals. If all rates above the ceilings must be reduced to the ceiling, the only way to recover average costs is to increase all rates below the ceiling up to the ceiling. This, the opinions and orders below do not permit.

A further regulatory inconsistency apparent on the face of the Commission's opinion, and not corrected by the Court of Appeals, is the requirement that refunds be made on any given sale where a producer has collected a contract price above the area ceiling rate, without taking account of the myriad other sales where the same producer, or other producers in the industry group, have collected contract prices *below* area ceiling rates. The area ceiling rates were determined by the Commission on the basis of composite group costs, where high costs incurred by some producers and as to some sales were averaged with low costs incurred by other producers and as to other sales. Under the opinion of the court below, however, rates must satisfy the "end-result" test of permitting recovery of revenue requirements. In testing the "end-result," industry *group revenues* at the area rates adjusted for quality differentials must be compared and balanced with the industry *group costs,* or revenue requirements, which were used to determine the area ceiling rates. If the existing rates, determined and tested on a group basis for the area, do not meet this test, clearly refunds below existing rates, which would result in still more inadequate rates and less recovery of revenue requirements, should not be ordered. Such refunds should not be ordered on the basis of revenues collected under individual contracts for given producer sales. Refunds, like rates, should be tested on the same standard of group revenue requirements.

This Court must correct the imposition of a moratorium on rate increases because such a moratorium would unlawfully freeze "just and reasonable" rate determinations, contrary to this Court's decision in *United Gas Improvement Co.* v. *Callery Properties,* 382 U.S. 223 (1965). In the *Callery* case, this Court recognized that the moratorium

conditions there imposed pursuant to certificate proceedings under Section 7 of the Natural Gas Act were valid only as an interim measure pending determination of just and reasonable rates in a subsequent rate proceeding under Sections 4 and 5 of the Act. Moreover, the interim certificate moratorium conditions before this Court in *Callery* limited filing for rate increases only above a "triggering" price level considerably higher than the "in-line" certificate price levels determined in that case. In this case, the purported just and reasonable rates for the Permian Basin Area have been determined; there is no basis for an interim Section 7 moratorium as in *Callery*.

The 2½ year moratorium on all rate increases and filings above applicable ceilings conflicts directly with the provisions of Sections 4 and 7 of the Natural Gas Act. Section 4 of the Act permits sellers of natural gas to file any contractually agreed rate changes subject only to the express statutory 30 day delay required to give notice of the rate change and subject to the Commission's discretion to suspend the rate change for another five months. The Act, in thus expressly authorizing up to six months' "moratorium" on a rate change, precludes the Commission from imposing a much longer moratorium not sanctioned by Congress or completely prohibiting filing for certain rate increases. Section 7 permits buyers and sellers initially to set rates by contracts and sellers to apply for certificates at such rates, relegating the Commission's role to one of review.

In further failing to involve itself at all with any judicial review of the Commission's costing methods, data and results, the Court of Appeals has abjectly abdicated its ordained judicial review functions under § 19 of the Natural Gas Act. This manifest and admitted dereliction of the

Court would deprive Petitioners and all other producers of any effective judicial review whatever of Commission actions in ratemaking because rates are made on the basis of costs. This deprivation of due process is also clearly contrary to the review functions of the Court of Appeals and such decision is in conflict with the decision of the Court of Appeals for the District of Columbia Circuit in *Mississippi River Fuel Corporation* v. *Federal Power Commission,* 163 F. 2d 433 (1947). In that case the Court held in detail that the proper judicial review of regulatory ratemaking must involve review in some detail of the propriety of the elements composing the total rate. There the Court, rejecting the Commission's contention that the judicial review function in ratemaking should be circumscribed, stated in part:

> ". . . The Commission seems to contend that the court must examine the rate per se, as an *abstraction,* or as a *naked economic fact, divorced from the elements of which it is composed and regardless of its effect;* and if it appears fair and reasonable upon such examination, it must stand. Such contention is without merit, either upon reason or upon authority, and moreover is impossible of practice.
>
> * * *
>
> ". . . So far as we know, *there is no rate case in American reports in which the proper rate has not been determined by a determination of these components and then their combination into a total. And there is no reported court review which was not concerned with one or more of those components.* Constitutional restrictions upon government control of public utility rates have been held by the courts to require this sort of process.
>
> * * *

> "It follows from the foregoing that a court can review the fairness, reasonableness and non-confiscatory character of a rate *only by reviewing the propriety of the elements of which the rate was composed.* No other way is known to our law, or ever was followed by any authority so far as we know. No standard is available for use in any other process of review." [emphasis supplied.]

For all practical purposes the court below approved the rate levels established by the Commission. The attention of the court was especially directed to hundreds of pages of expert witness testimony in the record before it attesting the need of prices in the order of 20 cents per Mcf. The attention of the court was especially directed to over 100 pages of exhibits in the record before it further demonstrating the need for prices at or above 20 cents per Mcf. This Court must decide if this relevant and decisive evidence was properly ignored, or if such evidence should have compelled the establishment by the Commission of higher rates.

The questions presented in this landmark case are substantial and important questions of law affecting the ultimate welfare of the entire natural gas producing industry of the nation and the consuming public relying upon that industry. This case may well be the culmination of the titanic effort of the Commission to find a solution to producer regulation over the past 13 years. Also, the court's decision below is in conflict with other judicial decisions, and as has been shown above, there is likelihood that petitioners will succeed in having that decision reversed respecting all or some of the questions presented.

CONCLUSION

WHEREFORE, Petitioners respectfully pray that the Court grant a writ of certiorari to the United States Court of Appeals for the Tenth Circuit to review the questions presented herein.

Respectfully submitted,

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By .....
Bruce R. Merrill
for Petitioners

Dated at Houston, Texas
April 14, 1967

APPENDIX

APPENDIX A

UNITED STATES COURT OF APPEALS
TENTH CIRCUIT

Nos. 8385, 8409, 8440, 8455, 8458, 8460, 8479, 8482, 8487, 8488, 8489, 8490, 8493, 8494, 8495, 8496, 8497, 8501, 8505, 8510, 8511, 8517, 8519, 8521, 8528, 8529, 8534, 8540, 8541, 8542, 8588 and 8589

JANUARY TERM, 1967

SKELLY OIL COMPANY; PHILLIPS PETROLEUM COMPANY; WARREN PETROLEUM CORPORATION; MOBIL OIL CORPORATION (formerly Socony Mobil Oil Company, Inc.); PAN AMERICAN PETROLEUM CORPORATION; NORTHERN NATURAL GAS PRODUCING COMPANY; STANDARD OIL COMPANY OF TEXAS, a Division of Chevron Oil Company; TEXACO INC.; HUNT OIL COMPANY jointly with H. L. Hunt, Lamar Hunt, N. B. Hunt, W. H. Hunt, Secure Trusts, Caroline and Loyd B. Sands, Caroline Hunt Trust Estate, Lyda Hunt-Caroline Trusts, Lyda Hunt-Bunker Trusts, Lyda Hunt-Lamar Trusts, Lyda Hunt-Herbert Trusts, Lyda Hunt-Margaret Trusts (formerly Estate of Lyda Bunker Hunt, Deceased), Hunt Industries (formerly Estate of Lyda Bunker Hunt, Deceased), and Placid Oil Company; HUMBLE OIL & REFINING COMPANY; SHELL OIL COMPANY; THE ATLANTIC RICHFIELD COMPANY (formerly The Atlantic Refining Company) jointly with Dorchester Gas Producing Company, Southland Royalty Company, and Westates Petroleum Company; CONTINENTAL OIL COMPANY jointly with Sunray DX Oil Company, Sinclair Oil & Gas Company, Cabot Corporation, Sohio Petroleum Company, Joseph E. Seagram & Sons, Inc., Joseph E. Seagram & Sons d/b/a Texas Pacific Oil Company, Gulf Oil Corporation, Murphy Oil Corporation, The Nueces Company, Samedan Oil Corporation, Cities Service Oil Company (formerly Cities Service Petroleum Corporation), Cities Service Production Company (now merged with Cities Service Oil Company), Columbian Fuel Corporation, Amerada Petroleum Corporation, Union Oil Company of California and as successor to The Pure Oil Company, Tidewater Oil Company, Reef Corporation, and

(Continued on next page)

William A. & Edward R. Hudson, Joint Operators; MARATHON OIL COMPANY; SUN OIL COMPANY; INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA; THE BRITISH-AMERICAN OIL PRODUCING COMPANY; UNION TEXAS PETROLEUM, a Division of Allied Chemical Corporation; MIDHURST OIL CORPORATION; THE SUPERIOR OIL COMPANY; PERRY R. BASS jointly with Panther City Investment Co., Bass Bros. Enterprises, Inc., Perry R. Bass, Incorporated, and Richardson Oils, Inc.; COLUMBIAN CARBON COMPANY jointly with Coltexo Corporation; THE STATE OF TEXAS; BIG CHIEF DRILLING COMPANY jointly with King-Stevenson Oil Company, Inc., and Service Drilling Company; TEXAS INDEPENDENT PRODUCERS AND ROYALTY OWNERS ASSOCIATION jointly with West Central Texas Oil and Gas Association; STATE OF NEW MEXICO; GULF OIL CORPORATION; and J. C. BARNES, et al.,

Petitioners,

v.

FEDERAL POWER COMMISSION,

Respondent,

STATE OF CALIFORNIA jointly with Public Utilities Commission of the State of California; CITY OF LOS ANGELES; CITY OF SAN DIEGO; CITY AND COUNTY OF SAN FRANCISCO; PACIFIC GAS AND ELECTRIC COMPANY; PACIFIC LIGHTING SERVICE AND SUPPLY COMPANY (formerly Pacific Lighting Gas Supply Company) jointly with Southern California Gas Company and Southern Counties Gas Company of California; and SAN DIEGO GAS AND ELECTRIC COMPANY,

Intervenors.

ON PETITION TO REVIEW ORDERS
OF THE FEDERAL POWER COMMISSION

Sherman S. Poland for Skelly Oil Company, petitioner in No. 8385. With him on the brief were Hawley C. Kerr, Richard J. Dent, Bradford Ross, and Ross, Marsh & Foster. Kenneth Heady, Carroll L. Gilliam, Jesse H. Foster, Jr., Oliver L. Stone, James J. Flood, Jr., Bruce R. Merrill, and Warren M. Sparks for the petitioners in Nos. 8409, 8440, 8455, 8458, 8460, 8482, 8488, 8489, 8490, 8493, 8494, 8497, 8505, 8517, 8534, 8540, 8541, 8542, 8588, and 8589. With them on the briefs were:

Thomas H. Burton, Jr., and Joseph C. Johnson for Continental Oil Company;

J. P. Greve for Sunray DX Oil Company;

A. A. Davidson, Charles Holmes, and Charles E. McGee for Sinclair Oil & Gas Company;

Homer D. Johnson and Boyd D. Taylor for Cabot Corporation;

Dixon Morgan, McAfee, Hanning, Newcomer, Hazlett & Wheeler, and Richard F. Remmers for Sohio Petroleum Company;

Eldon E. Scott, Donald J. Mulvihill, and Cahill, Gordon, Reindel & Ohl for Joseph E. Seagram & Sons, Inc., and Joseph E. Seagram & Sons d/b/a Texas Pacific Oil Company;

H. Y. Rowe for Murphy Corporation;

Chester L. Wheless for The Nueces Company;

George N. Otey, Jr., for Samedan Oil Corporation;

John C. Snodgrass and Vinson, Elkins, Weems & Searls for Union Oil Company and as successor to The Pure Oil Company;

Clyde E. Willbern for Tidewater Oil Company;
T. J. Caldwell, Jr., and Jerome M. Alper for Reef Corporation;

Edward R. Hudson for William A. & Edward R. Hudson, Joint Operators;

All as joint and several petitioners in No. 8493;

Cecil N. Cook and Neal Powers, Jr., for Midhurst Oil Corporation, petitioner in Nos. 8493 and 8505;
Wm. J. Zeman, Lloyd G. Minter, John R. Rebman, and Stanley L. Cunningham for Phillips Petroleum Company, petitioner in No. 8409;

Donald R. Arnett and Kenneth C. Keener for Gulf Oil Corporation, petitioner in Nos. 8493 and 8534, and Warren Petroleum Corporation, petitioner in Nos. 8493 and 8440;

Cecil C. Cammack, R. J. Leithead, and Graydon D. Luthey for Cities Service Oil Company (formerly Cities Service Petroleum Company), Cities Service Production Company (now merged with Cities Service Oil Company), and Columbian Fuel Corporation, petitioners in No. 8493, and Coltexo Corporation and Columbian Carbon Company, petitioners in No. 8517;

Joseph W. Morris and Edwin S. Nail for Amerada Petroleum Corporation, petitioner in Nos. 8493 and 8542;

Tom P. Hamill; Robert D. Haworth, Donald G. Canuteson, and D. Lamar Smith for Mobil Oil Corporation (formerly Socony Mobil Oil Company, Inc.), petitioner

in Nos. 8455 and 8588, and Northern Natural Gas Producing Company, petitioner in No. 8460;

J. P. Hammond, T. C. McCorkle, William H. Emerson, and Clifford O. Stone, Jr., for Pan American Petroleum Corporation, petitioner in No. 8458;

William K. Tell, Jr., for Texaco Inc., petitioner in Nos. 8482 and 8541;

Carl Illig and William H. Holloway for Humble Oil & Refining Company, petitioner in No. 8488;

Thomas G. Johnson for Shell Oil Company, petitioner in No. 8489;

Stuart J. Scott, Bernard A. Foster, Jr., and Ross, Marsh & Foster for The Atlantic Richfield Company (formerly The Atlantic Refining Company), Southland Royalty Company, Westates Petroleum Company and Dorchester Gas Producing Company, petitioners in No. 8490, and The British-American Oil Producing Company, petitioner in No. 8497;

Clayton L. Orn, Joseph F. Diver, Morton Taylor, and Jack Fariss for Marathon Oil Company, petitioner in Nos. 8494 and 8540;

F. H. Pannill, Hamilton E. McRae, and Stubbeman, McRae, Sealy & Laughlin for J. C. Barnes, et al., petitioners in No. 8589.

Claude Proctor, Justin R. Wolf, Eugene E. Threadgill, and Wolf & Case were on the brief for Standard Oil Company of Texas, a Division of Chevron Oil Company, petitioner in No. 8479.

Robert W. Henderson for Hunt Oil Company, et al., petitioners in No. 8487. With him on the brief was Paul W. Hicks.

Louis Flax for Sun Oil Company, petitioner in No. 8495. With him on the brief were Phillip D. Endom, Robert E. May, and May, Shannon and Morley.

William I. Powell for Independent Petroleum Association of America, petitioner in No. 8496. With him on the brief was L. Dan Jones.

H. W. Varner for Superior Oil Company, petitioner in No. 8510. With him on the brief was Murray Christian.

J. Evans Attwell for Perry R. Bass, et al., petitioners in No. 8511. With him on the brief were W. H. Drushel, Jr., and Vinson, Elkins, Weems & Searls.

Waggoner Carr, Attorney General, for the State of Texas, petitioner in No. 8519. With him on the brief were Hawthorne Phillips, First Assistant Attorney General, T. B. Wright, Executive Assistant, J. Arthur Sandlin, C. Daniel Jones, Jr., and Linward Shivers, Assistant Attorneys General, of the State of Texas.

Lewis G. Mosburg, Jr., for Big Chief Drilling Company, et al., petitioners in No. 8521. With him on the brief were A. P. Murrah, Jr., Leland C. Neeley, Jr., Mosteller, Andrews & Mosburg, Jerry F. Lyons, and Underwood, Wilson, Sutton, Heare & Berry.

John Davenport for Texas Independent Producers & Royalty Owners Association and West Central Texas Oil and Gas Association, petitioners in No. 8528.

Boston E. Witt, Attorney General, and William J. Cooley, Special Assistant Attorney General, for the State of New Mexico, petitioner in No. 8529.

Richard A. Solomon, General Counsel, and Peter H. Schiff, Deputy Solicitor, Federal Power Commission, for the respondent. With them on the brief were Howard E. Wah-

renbrock, Solicitor, Leo E. Forquer, David J. Bardin, Assistant General Counsels, Alan J. Roth, and James D. Annett, Attorneys, Federal Power Commission.

J. Calvin Simpson, Senior Counsel, for People of the State of California, Public Utilities Commission of the State of California, City of Los Angeles, City of San Diego, and City and County of San Francisco, intervenors. With him on the brief were:

Mary Moran Pajalich, Chief Counsel, and William N. Foley, Associate Counsel, for the People of the State of California and Public Utilities Commission of the State of California;

Roger Arnebergh, City Attorney, for the City of Los Angeles;

Edward T. Butler, City Attorney, and Edwin L. Miller, Jr., Assistant City Attorney, for the City of San Diego;

Thomas M. O'Connor, City Attorney, William F. Bourne, Public Utilities Counsel and Deputy City Attorney, and McMorris M. Dow, Deputy City Attorney, for the City and County of San Francisco.

William L. Cole, Malcolm H. Furbush, and C. Hayden Ames for Pacific Gas and Electric Company, Pacific Lighting Service and Supply Company (formerly Pacific Lighting Gas Supply Company), San Diego Gas & Electric Company, Southern California Gas Company and Southern Counties Gas Company of California, intervenors. With them on the brief were:

John Ormasa and Roger J. Nichols for Pacific Lighting Service and Supply Company, Southern California Gas Company, and Southern Counties Gas Company of California;

Frederick T. Searls and Stanley T. Skinner for Pacific Gas and Electric Company;

Sherman Chickering and Donald J. Richardson, Jr., for San Diego Gas & Electric Company.

A brief Amicus Curiae supporting respondent was filed by J. David Mann, Jr., John E. Holtzinger, Jr., Frederick Moring, and Morgan, Lewis & Bockius on behalf of the Associated Gas Distributors Group.

Oklahoma Independent Petroleum Association, A & R Pipe Co., et al., Panhandle Producers & Royalty Owners Association, and Malouf Abraham Company, et al., joined in the brief of Big Chief Drilling Company, et al., as Amicus Curiae supporting petitioners.

Before LEWIS, BREITENSTEIN and HILL,
Circuit Judges.

BREITENSTEIN, Circuit Judge.

The first area rate decision of the Federal Power Commission is before us for review. It relates to prices for jurisdictional sales of natural gas produced in the Permian Basin, a famous petroleum area where oil and gas are found in hundreds of reservoirs and thousands of wells. The states of Texas and New Mexico, the nation's oil and gas industry, and several related associations attack the decision. The State of California, the cities of San Francisco, Los Angeles, and San Diego, various local distributors, and an organization of such distributors support it. The rejection of the individual company cost-of-service approach to the regulation of independent producers and the adoption of the area rate method raise many novel issues which have been extensively and ably argued. We hold that neither the United States Constitution nor the Natural Gas Act bars the regulation of natural-gas prices on an area basis; that the Commission did not abuse its discretion in adopting the area method; and that the cases must be remanded because the actions of the Commission do not comply with the end result test established in Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 602-603, and other decisions.

The petitions for review, all brought under § 19(b) of the Natural Gas Act,[1] attack Opinions Nos. 468 and 468-A of the Commission fixing just and reasonable rates under

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[1] 15 U.S.C. §§ 717-717w.

§§ 4 and 5 of the Act for natural gas produced in the Permian Basin and sold to interstate pipeline companies.

1. **Background.**

The Permian Basin, as defined by the Commission, includes Texas Railroad Commission Districts Nos. 7-C, 8, and 8-A and the New Mexico counties of Chaves, Eddy, and Lea. Nationally, it accounts for about 11% of all the gas sold in interstate commerce. The Commission joined 336 producers as respondents in the consolidated proceedings. Sales by them are made to three interstate pipelines, none of which appear here.[2] About 85% of the Permian gas moving interstate goes to California.

Nearly two-thirds of the Permian gas production comes from oil-well gas, that is, gas produced in conjunction with oil. Because of impurities much of the gas must be processed before introduction to an interstate pipeline. Until El Paso began its purchases, Permian oil-well gas was generally vented or flared because of the lack of a market.

The natural-gas industry has three main parts, the producers, the interstate pipelines, and the distributors. The last are under state or local regulation exclusively. The Commission began federal regulation of the interstate pipelines after the passage of the Natural Gas Act of 1938. It did not attempt to regulate independent producers[3] until the 1954 decision of the Supreme Court in Phillips Petro-

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[2] El Paso Natural Gas Company began buying Permian gas in 1945, Northern Natural Gas Company through a predecessor in 1954, and Transwestern Pipeline Company in 1958. In 1961, El Paso purchased 73% of the Permian gas moving in interstate commerce, Northern 18%, and Transwestern 9%.

[3] The word "independent" is used to describe a producer which does not transmit gas interstate either by its own operations or those of an affiliate. Some of the interstate pipelines produce a share of their own gas and sell gas to other pipelines.

leum Co. v. Wisconsin, 347 U.S. 672, (First Phillips) which held that the Act applied to them.

Section 7 of the Act forbids the sale of natural gas subject to Commission jurisdiction without a certificate of public convenience and necessity granted after notice and hearing. Temporary certificates, issued without notice and hearing, are authorized. Our recent decision in Sunray DX Oil Company v. Federal Power Commission, 10 Cir., ... F. 2d ....., discusses § 7 procedures and problems. These are not present here because the § 7 applications considered in the consolidated proceedings before the Commission were disposed of in a separate order.

Section 4 requires that all rates shall be just, reasonable, and nondiscriminatory. No change shall be made in a rate without 30 days' notice. When a schedule containing a changed rate is filed, the Commission on its own initiative or on complaint may suspend the rate and set the matter for hearing. The suspension may be for not longer than five months. If no decision is reached within that period, the increased rate becomes effective but the Commission may require a bond conditioned upon the refund of that portion of the increased rate found not to be justified. The instant proceedings involve a number of increased rate filings which were suspended under § 4 and which were disposed of by Opinions Nos. 468 and 468-A.

Section 5 provides that whenever the Commission, after hearing had on its own motion or on complaint, finds that a rate is "unjust, unreasonable, unduly discriminatory, or preferential" it shall determine "the just and reasonable rate." In the proceedings at bar the Commission pursuant to § 5 established "the future rates for jurisdictional sales of gas by producers in the area."

After the First Phillips decision the Commission received thousands of certificate applications from producers. The situation was complicated by the need of pipelines for a committed source of supply sufficient to justify financing. To obtain such supply long-term contracts, commonly for 20 years, were made with the producers. They in turn, because they could not file unilaterally for an increased rate contrary to contract and because they desired protection against the unforeseeable economic conditions of the future, insisted on escalation clauses of various types.[4] A general price rise occurred. As the escalation provisions became operative the producers filed under § 4 for increased rates and the Commission suspended many of them. Section 7 applications were under contracts calling for rates comparable to those which the Commission had suspended. This trend was ended by the 1959 decision in Atlantic Refining Co. v. Public Service Commission of New York, 360 U.S. 378, (CATCO) which directed the Commission in certificate cases to keep initial prices in line.

After the remand in First Phillips, the Commission proceeded with the consideration of just and reasonable rates required by §§ 4 and 5 on the individual company cost-of-service basis which it had long applied in the regulation of electric power companies and interstate pipelines. The first case to reach the decisional stage was that relating to Phillips. On September 28, 1960, the Commission entered Opinion No. 338[5] in which it held that the regulation of independent producers under the Act could be accomplished more appropriately by the establishment of area rates than by the establishment of producer rates on individual cost-of-service findings. Contemporaneously with this Phillips

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[4] See Pan American Petroleum Corporation v. Federal Power Commission, 10 Cir., 352 F. 2d 241, 243.

[5] 24 FPC 537.

decision, the Commission promulgated its Statement of General Policy No. 61-1[6] which established 23 rate areas and, with unimportant exceptions, announced maximum rates for each area. Two price standards were set, one for initial prices in new contracts and one for escalated prices in existing contracts. For the Permian Basin area the prices were 16 cents and 11 cents respectively.

Opinion No. 338 was affirmed by the Court of Appeals for the District of Columbia Circuit[7] and by the Supreme Court in Wisconsin v. Federal Power Commission, 373 U.S. 294, 310, (Second Phillips) wherein the Court observed that it shared "the Commission's hopes that the area approach may prove to be the ultimate solution" to the problem of regulating the independent producers.

The first area rate proceeding was that for the Permian Basin and was initiated on December 23, 1960.[8] It was followed by a similar proceeding for the South Louisiana area,[9] for the Hugoton-Anadarko area,[10] and for the Texas Gulf Coast area.[11] The last three are in the hearing stage. The Permian Basin proceeding was decided by Opinions Nos. 468 and 468-A to which we turn.

2. The Decision of the Commission.

The 131-page original opinion, No. 468, followed by the 23-page opinion denying rehearing, No. 468-A, need only be summarized at this point. The Commission found the area rate principle free from constitutional and statutory

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[6] 24 FPC 818.

[7] Wisconsin v. Federal Power Commission, D.C. Cir., 303 F. 2d 380.

[8] Docket No. AR61-1, 24 FPC 1121.

[9] Docket No. AR61-2, 25 FPC 942.

[10] Docket No. AR64-1, 30 FPC 1354.

[11] Docket No. AR64-2, 30 FPC 1354.

objections and adopted it. Contract prices were rejected as a basis for regulation and the reserves to production ratio was declared to be an inappropriate regulatory standard. The Commission set up a two-price system. It differentiated between gas produced as the sole product of a well, referred to as gas-well gas, and gas produced in association with oil, known as oil-well gas or casinghead gas. One price was established for new gas-well gas and the residue therefrom sold under contracts made on or after January 1, 1961. A second price was established for flowing gas which was defined to include gas-well gas sold under contracts executed before the mentioned date, casinghead gas, and residue gas derived from either source. The January 1, 1961, date of division between new gas-well gas and oil gas-well gas was adopted because that was the approximate date when the industry became able to direct its exploration efforts toward finding gas-well gas as distinguished from finding gas as a by-product in the search for oil. For new gas-well gas the Commission fixed a rate of 16.5 cents per Mcf for the Texas Railroad Districts inclusive of state and local taxes and a rate of 15.5 cents per Mcf for the New Mexico counties exclusive of applicable state and local production taxes. For flowing gas the respective rates were 14.5 cents and 13.5 cents.

In determining these rates the Commission gave consideration to composite costs but treated the two categories of new gas-well gas and flowing gas differently. It said that the price of the former "was geared to the cost of finding and producing future gas supplies and as such was built up primarily from nationally published statistics and the questionnaire data." For flowing gas it said "our touchstone is the historical cost of gas being produced in the Permian Basin area."

The Commission required adjustment on an individual company basis from the stated prices to reflect differentials from the quality standards. These downward adjustments are determined "by the net cost of processing the gas to bring it up to standard." A downward adjustment is also required if the Btu content is less than 1,000 per Mcf and an upward adjustment is permitted if that content is above 1,050.

Small producers, defined as those making less than 10 million Mcf of jurisdictional sales annually, are exempt from the quality adjustments and from certain filing requirements.

The Commission set a minimum price of 9.0 cents per Mcf. Provision is made for special exemption from area rates. Refunds of excess collections are required on an individual company basis. The possibility of changes in area rates is recognized. A moratorium, until January 1, 1968, is declared on rate increases and indefinite escalation clauses are prohibited.

Three commissioners filed separate opinions. With one exception Commissioner O'Connor approved the results reached but said that "the contract price at which most producers are able and willing to operate is just and reasonable" and that "composite costs best serve as a check on average field prices to preclude significant price departures." He disapproved the Btu adjustment saying that an upward adjustment should be applied for all gas having a Btu content in excess of 1,000. Comissioner Ross was critical of accounting methods used and pointed out the need for simplification. He dissented from the division date between new and old gas-well gas. In his view the new gas-well gas price should apply to gas sold after the date of the Commission decision. Commissioner Black said that the allowed 12% rate of return on net investment "is

very probably a generous one" but was justified by the special risk of finding substandard gas in the Permian Basin.

3. Disqualification of Two Commissioners.

The Continental Group of petitioners urges that Commissioner Black was disqualified to participate in the decision. The Independent Petroleum Association of America, (IPAA) complains of the participation of both Commissioners Swidler and Black. The claim is that each of them had prejudged the issue of whether substantial competition existed among producers. Additionally, Commissioner Black is accused of personal bias against the producers. The charges stem from public addresses made in 1964.[12] No claim is made that either commissioner prejudged the ultimate issue of a just and reasonable rate. In our opinion no basis for disqualification arises from the fact or assumption that a member of an administrative agency enters a proceeding with advance views on important economic matters in issue. Nothing in the record disturbs the assumption that the two commissioners are "men of conscience and intellectual discipline, capable of judging a particular controversy fairly on the basis of its own circumstances."[13] The cases cited by Continental and IPAA are not in point.[14]

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[12] A motion for the disqualification of Commissioner Black was made to and denied by the Commission. We find no similar motion in the record pertaining to Commissioner Swidler.

[13] United States v. Morgan, 313 U.S. 409, 421. See also Federal Trade Commission v. Cement Institute, 333 U.S. 683, 700-703.

[14] In Texaco, Inc., v. Federal Trade Commission, D.C. Cir., 336 F. 2d 754, vacated 381 U.S. 739, the charge was precommitment of a commissioner on the guilt of an accused. In Gilligan, Will & Co. v. Securities and Exchange Commission, 2 Cir., 267 F. 2d 461, certiorari denied 361 U.S. 896, a similar charge was made

4. Objections of Texas and New Mexico.

The states of Texas and New Mexico, besides adopting the briefs and arguments of the Continental Group, assail the Commission decision on grounds peculiar to them in their governmental capacity. They say that the public interest, which the Commission is required to protect, includes the producing states as well as the consuming states; that the prices which the Commission has set will cause a cessation or curtailment of exploration and development activities to the serious injury of the economy of the Permian Basin; that waste rather than conservation of a natural resource will result; and that the states and their public entities will suffer severe losses in taxes and royalty payments.[15] Similar arguments were made by West Virginia in Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 607-614, and were rejected by the Supreme Court which said that when Congress passed the Natural Gas Act it "was quite aware of the interests of the producing states in their natural gas supplies" and that nothing in the Act intimates that high prices should be maintained so that "the producing states obtain indirect benefits." The rejection of the state's contentions in Hope requires the rejection of the same contentions here.

Texas and New Mexico also argue that the Commission has unlawfully interfered with their power of taxation.

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against a commission. Amos Treat & Co. v. Securities and Exchange Commission, D.C. Cir., 306 F. 2d 260, related to a charge against a commissioner who had previously served as a staff member in the investigation which led to the complaint.

[15] In Texas 4.7 million acres of public lands are within the Permian Basin and in New Mexico over 3 million acres. Much of this land is leased for oil and gas and produces royalty income.

The Commission fixed the rates of gas produced in Texas to include all state taxes and in New Mexico to exclude such taxes. It said that: "In the event of any increase in taxes in Texas or New Mexico, the Commission will consider whether ceiling prices shall be increased and, if so, to what extent." The states' arguments are premature. The Commission has allowed all present taxes as a cost item. Nothing in the Commission decision inhibits the states from increasing those taxes. The Commission has said that if they do, it will determine whether such increases should be passed on to the consumer or remain on the shoulders of the producers. The question of whether increased state taxes will unreasonably burden interstate commerce is hypothetical at this stage.

New Mexico complains that the establishment of a ceiling price plus existing taxes for gas produced in its portion of the Permian Basin denies to it the power to provide a tax incentive to producers by reducing the tax. The argument is not persuasive. If the New Mexico tax was reduced, the Commission could properly consider a rate decrease to reflect the tax decrease.

5. Legality of Area Rates for Permian Basin.

The problems confronting federal regulation of the natural-gas business, and particularly the independent producers, have been discussed several times[16] and need be only summarized. The interstate gas business is concerned with a wasting, nonreplenishable natural resource subject to production after discovery. At the point where the gas enters interstate commerce there are few buyers and thou-

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[16] See opinions of Justice Jackson dissenting in Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 628, and concurring in Colorado Interstate Gas Co. v. Federal Power

sands of sellers. The producers range from the financially powerful integrated oil companies to the wildcatters who operate on a shoestring. Their results are measured by the amount of gas produced — not by the amount of money invested. Exploration and development costs are financed out of current income and are charged to expense rather than capital. The uncertainty of the business causes substantial cost and revenue fluctuations not only from producer to producer but also from year to year for the same producer. A regulated commodity, gas, is produced in substantial quantities along with an unregulated commodity, oil. The allocation of costs between them baffles the experts and presents the temptation to use mathematical means of arriving at a predetermined result. The same rate may bring a financial windfall to one producer and a financial disaster to another. The price of gas must be competitive with that of other sources of energy and must be sufficienlty attractive to encourage a continued search for new supplies.

In Federal Power Commission v. Natural Gas Pipeline Co., 315 U.S. 575, 582, a case relating to pipeline rates, the Court held that the provisions of the Act were consistent with the due process clause of the Fifth Amendment and within the commerce power. Another pipeline case, Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 602, says that in fixing rates the Commission is "not bound by the use of any single formula or

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Commission, 324 U.S. 581, 608; dissenting opinion of Justice Douglas in First Phillips, 347 U.S. 672, 687; dissenting opinions of Justice Clark in First Phillips, 347 U.S. 672, 690, and in Second Phillips, 373 U.S. 294, 315; dissenting opinion of Justice Harlan in Sunray Mid-Continent Oil Co. v. Federal Power Commission, 364 U.S. 137, 159; and Opinion No. 338 of the Commission, 24 FPC 537, 542-548.

combination of formulae"; that "under the statutory standard of 'just and reasonable' it is the result reached not the method employed which is controlling"; and that the impact of the rate order rather than the theory behind it is the governing criterion. The "end result" test of Hope was followed in Colorado Interstate Gas Co. v. Federal Power Commission, 324 U.S. 581, 605-606.

Second Phillips, 373 U.S. 294, holds that the Commission did not abuse its discretion in terminating the § 5 investigation of Phillips' rates and substituting an area basis for an individual company basis. The Court reaffirmed the principles announced in Natural, Hope, and Colorado Interstate, recognized the difficulties inherent in the regulation of the price of natural gas, shared the Commission's hope for the success of the area approach, and observed that the "case might be different if the area approach had little or no chance of being sustained."[17] At the same time, the Court pointed out that "the lawfulness of the area pricing method" was not before it for review.[18] Four justices dissented in an opinion which characterized the area rate policy of the Commission as "a new, untried, untested, inchoate program which, in addition, is of doubtful legality."[19]

In Callery[20] the Court mentioned that the § 7 proceedings before it had at one time been consolidated with the South Louisiana area rate proceedings. Contrary to the argument of the California Distributors the Court did not, tacitly or otherwise, approve area rate regulation. The

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[17] 373 U.S. 294, 310, 314.

[18] Id. at 308.

[19] Id. at 317.

[20] United Gas Improvement Co. v. Callery Properties, Inc., 382 U.S. 223, 225-226.

most pertinent comment is that of Justice Harlan in his concurring and dissenting opinion who said that area pricing "ultimately aims to simplify proceedings under the statute."[20a]

We cannot accept the arguments of the Commission and the California groups that the Supreme Court has determined the validity of area pricing under the Act. We read the decisions to mean that the Court has permitted the Commision to go forward with the area rate experiment and wishes it good luck in the development of a workable procedure which will be free from constitutional and statutory pitfalls.

Governmental price regulation of services and commodities on a group or geographical basis has been upheld in a number of decisions[21] under the federal commerce and war powers and under state police powers. Those supporting the Commission place great reliance on these decisions. The producers painstakingly distinguish each from the case at bar. We decline to be drawn into these tortuous sidepaths because we are convinced that the "translation of an impli-

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[20a] Id. at 231.

[21] See The New England Divisions Case, 261 U.S. 184 (ICC — divisions of joint rates); Aetna Insurance Co. v. Hyde, 275 U.S. 440 (Missouri regulation of fire insurance rates); Tagg Bros. v. United States, 280 U.S. 420 (Packers and Stockyards Act of 1921); Nebbia v. New York, 291 U.S. 502 (New York Milk Control Act); United States v. Rock Royal Co-op., 307 U.S. 533 (Agricultural Marketing Agreement Act of 1937); Sunshine Anthracite Coal Co. v. Adkins, 310 U.S. 381 (Bituminus Coal Conservation Act); Bowles v. Willingham, 321 U.S. 503 (Emergency Price Control Act of 1942); New York v. United States, 331 U.S. 284 (ICC — railroad rates); and Ayrshire Collieries Corp. v. United States, 335 U.S. 573 (ICC — railroad rates).

cation drawn from the special aspects of one statute to a totally different statute is treacherous business."[22] Specific reference need be made to only one decision. Several producers emphasize the statement in Bowles v. Willingham, 321 U.S. 503, 517, that in the Natural Gas Act "Congress has provided for the fixing of rates which are just and reasonable in their application to particular persons or companies." The argument is that by this language the Supreme Court has recognized that regulation under the Act is on an individual company rather than group basis. We do not agree. The statement is dicta and whatever value it might have had as dicta was, in our opinion, destroyed by the blessing which the Court gave area rate making in Second Phillips.

Producers urge that the language of the Act is contrary to regulation on a group basis because all pertinent references to natural-gas companies are in the singular. First Phillips holds that an independent producer is a "natural-gas company" within the purview of the Act. Section 2, the definitions section, provides that "person" means an individual or corporation, and defines "natural-gas company" to mean a person engaged in transportation or sale of natural gas in interstate commerce. Section 4, covering the filing and changing of rates, refers to "any natural-gas company," "no natural-gas company," "every natural-gas company," and "the natural-gas company." Section 5, authorizing investigation and determination of rates, refers to "any rate," by "any natural-gas company" and to "such natural-gas company." Section 7 provides for certificates of public convenience and necessity and uses the terms "a natural-gas company," "no natural-gas company" and "such natural-gas company." The repeated use of the singular

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[22] Federal Trade Commission v. Bunte Bros., 312 U.S. 349, 353.

rather than the plural is said to require that the just and reasonable rate of each particular seller be tested with reference to its peculiar circumstances and operations.

Opposing arguments point out that the Act does not prohibit group or area rate making and that § 16 empowers the Commission to perform any and all acts and to prescribe such orders, rules, and regulations "as it may find necessary or appropriate to carry out the provisions of this act."

The basic query is whether the just and reasonable standard applies on an individual company basis or on a group basis. Section 4(a) says that "all rates * * * made * * * by any natural-gas company * * * shall be just and reasonable * * *." If this means that each producer is entitled to a rate which will return its costs plus a reasonable profit, the inquiry is at an end because the Commission refused to receive individual cost figures.

The Natural, Hope, Colorado Interstate, and Second Phillips decisions all support the conclusion that in the regulation of natural-gas rates the Commission is not bound by any formula or method, and that the choice of the appropriate method for the determination of those rates lies in the sound discretion of the Commission. The appropriateness of the method depends on the peculiar characteristics of the natural-gas industry.

In its Opinion No. 338,[23] the Commission noted the reasons why the individual company cost-of-service method was inapplicable and unworkable. Among these were the lack of a fixed determinable relationship between investment and service to the public with the result that "a huge investment might yield only a trickle of gas, while a small investment might lead to a bonanza," the staggering allocation problems which could result in such anomalies as

[23] 24 FPC 537.

widely varying prices for gas coming from a jointly owned lease or even from a jointly owned well, and the intolerable administrative burden of requiring a separate rate determination for each of the several thousand independent producers.

The powerful contrary argument is that no area rate, whether based on composite costs, average aggregate costs or any other industry wide criteria, will suffice to assure a high cost producer of its costs to say nothing of a profit. We accept this as true.[24] The impact of an area rate in the natural-gas industry may have effects which cover the entire range from bonanza to bankruptcy. It is sufficient for us that these results were lucidly demonstrated in the dissenting opinion of Justice Clark in Second Phillips and did not deter the majority from allowing the Commission to proceed with its area rate program.

Some of the producers argue that if the Act is construed to permit area rate making, the Act is invalid under Art. I, § 1, of the United States Constitution because no legislative standards have been set for establishing groups or making group determinations. Reliance is had on Panama Refining Co. v. Ryan, 293 U.S. 388, which held that a delegation of legislative power to the President was unconstitutional because Congress, among other things, "has declared no policy, has established no standard, has laid down no rule."[25]

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[24] An appendix to the Hunt brief presents an array of natural-gas costs of 44 Permian producers whose volumes total over 208 million Mcf. Of these, 16 producing over 170 million Mcf are shown to have costs of less than 14.5 cents. The remainder have costs running from 14.77 cents to 216.05 cents. We have been unable to check the accuracy of these figures and mention them only to show the claimed disparity of costs. Continental says that "approximately 67 percent of the companies and approximately 30 percent of the volumes had costs above the industry average cost level."

[25] 293 U.S. 388, 430.

Congress cannot delegate its power to enact laws but it can confer on an administrative agency the power to carry into effect laws which it has enacted.[26] In the New England Divisions Case, *supra,* the Court referred to the power given by Congress to the Interstate Commerce Commission to determine just and reasonable rates and said that Congress "intended that a method should be pursued by which the task * * * could be performed."[27] In Lichter v. United States, 334 U.S. 742, 785-786, the Court in discussing legislative standards said that the "standards prescribed by Congress are to be read in the light of the conditions to which they are applied" and for an example observed that "among those which have been held to state a sufficiently definite standard for administrative action [are] 'just and reasonable' rates for sales of natural gas."

In the regulation of the natural-gas industry "the actual necessities of procedure and administration"[28] have led to the adoption of the area rate method. We believe that neither constitutional nor statutory provisions prevent the use of that method and that the Commission did not abuse its discretion in adopting it. The more important and difficult question is that of the validity of the area rates which have been established. The controlling standard is the end result test of Hope. In our opinion, this test is accepted by, and reaffirmed in, the Second Phillips decision.

Some of the producers urge that the area rate method is not consistent with the characteristics of the industry and that contract prices satisfy statutory requirements because they have been reached through effective competition. The Commission considered and rejected the argument. It point-

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[26] Crain v. First National Bank of Oregon, Portland, 9 Cir., 324 F. 2d 532, 537.
[27] 261 U.S. 184, 197.
[28] Id. at 198.

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ed to the history of price negotiations in the Permian Basin, to the urgent requirements of the pipelines, to the heavy percentage of sales by a few producers, and to the control of undisclosed and uncommitted gas reserves by a few producers. It concluded that the record fails to establish that a just and reasonable rate can be established through competition and that "the primary competition revealed by the record was among the pipelines to secure new gas supplies at higher prices." Commissioner O'Connor disagreed saying that "the contract price at which most producers are able and willing to operate is just and reasonable." His conclusion was that "profit oriented costs and supply oriented contracts do not, in the aggregate, depart in any significant manner from each other." We accept the conclusion of the Commission that competition has not been effective to fix a just and reasonable rate. It is supported by reasonable inferences from the record and they are binding on us.

Continental and Superior say that they were improperly denied an opportunity to be heard on the geographical propriety of the Permian Basin as a rate area. In its order instituting the proceedings the Commission eliminated the issue of the appropriateness of the area for rate making purposes.[29] The Commission may draw on its expertise to determine the ground rules for an investigation but in so doing may not deny a specific right.[30] The producers fail to convince us that any such denial has occurred here. The Permian Basin is a well known area. Unless prices are to be determined on a national basis, areas must be selected and defined. The Commission had two choices. It could first determine the national revenue requirement and di-

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[29] 24 FPC 1121, 1122.

[30] Amax Petroleum Corporation v. Federal Power Commission, 10 Cir., 350 F. 2d 92, 94.

vide that up among the areas or it could first determine the various rates so that in the aggregate they meet that requirement. We are unwilling to assume that when all the area proceedings are completed the total revenue will not equal the national requirement. If it does not, both the producers and the consumers will suffer. In our opinion the Commission acted reasonably in selecting the Permian Basin for an area rate proceeding.

6. **The Two-Price System.**

The Commission's two-price system is vigorously attacked on many fronts. It will be remembered that one price is fixed for new gas-well gas and another for flowing gas. All agree that gas is a commodity which is valuable as a source of energy. The householder does not care whether the gas which burns at the tip of his appliance comes from a gas well, an oil well, or as a residue product. To him gas is gas.

The justification for the two-price system is that the higher price for new gas-well gas provides an incentive to explore for and develop new supplies. The producers do not question the finding that "the industry is increasingly becoming able to direct its exploration efforts toward finding new gas-well gas as distinguished from finding gas as a by-product in the search for oil." This ability may be confined to the larger companies which maintain the technical staffs skilled in making the necessary predictions. The smaller producers are in a less advantageous position. They may be relegated to the farmouts which the majors pass down to them or to operations in accord with their less scientific but sometimes financially rewarding hunches.

New gas discoveries are well said to be the life blood of the industry. The consumers may reasonably be required to pay the price needed to bring forth such discoveries. If

an incentive price based on current costs is used for all gas, windfalls will be assured to many producers of old gas developed under lower historical costs and often found in association with oil.

The producers say that a single-price system based on current costs is required because revenues for current exploration and development must be internally generated from sales of gas from whatever source. The Commission rejected the argument. The question is not so much the source of the funds as it is the inducement to use available funds in the search for gas. The higher price for new gas is intended to supply that inducement. Although the adequacy of the inducement can only be tested by future developments, we are not convinced that the refusal of the Commission to include the same inducement in the price of old gas, with the resulting likelihood of wind-falls, was unreasonable.

Continental, Phillips, and others argue that the two-price system amounts to entrapment because of the possibility of reduction in price after financial commitments have been made. Although the Commission which announced the Permian Basin decision cannot bind a future Commission, we credit the Commission with good faith. The possibility of a change does not invalidate the rate method employed. When and if a reduction occurs, the argument of entrapment can be heard.

The division date of January 1, 1961, for the different prices of new gas-well gas and old gas-well gas is another subject of dispute. Here the Commission found as a fact that the appropriate date was the approximate time when directional drilling came to be used effectively. Under the evidence the selection of a division date was an administrative problem calling for the exercise of judgment. In making its choice the Commission acted within the evidence and

within its powers. On rehearing, the Commission left open for future consideration the problem arising when new gas-well gas is developed from committed acreage. We assume that this problem will be met fairly when it comes to a head.

The two-price system is an outgrowth of directional drilling for gas. Its purpose is to assure a continued gas supply. The Commission frankly says that the adoption of the system for the Permian Basin "should serve to furnish a practical test of whether in fact it will result in bringing forth additional supplies." We find no persuasive reason why the test should not be made.

7. The Cost Information.

In arriving at the Permian Basin rates the Commission used many sources of cost information. These included responses to questionnaires sent to producers, the Census of Mineral Industries for 1958, the Chase Manhattan Bank's 1961 Annual Analysis of the Petroleum Industry, the World Oil Magazine, the Oil and Gas Journal, the Joint Association Survey,[31] and others. The producers attack these sources on many and varied grounds. The range of objections runs from hearsay evidence through deprivation of right of cross-examination to denial of procedural due process. To take up each of these objections would increase the length of this opinion to encyclopedic dimensions.

From the information so obtained the parties, the staff, and the Commission make many computations and reach many results. The assumptions, allocations, formulae, equations, averages, means, and massive calculations may intrigue a mathematician or statistician but they have no

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[31] This is a survey of a few producers conducted by the American Petroleum Institute, the IPAA, and the Mid-Continent Oil and Gas Association.

attraction for us. We respectfully decline to be drawn into such a turmoil of numbers. We cannot in a few months unravel the snarl of statistics developed in the years of hearings. In our opinion the judicial process, in cases such as this, should be confined to consideration of errors of law. We leave to the experts the selection of source material and the calculations to be made therefrom. Our concern is with the result.

8. **The Commission's Price Determinations.**

The Commission said that "costs must be a major factor in determining the area price." On the basis of current national statistics plus questionnaire data it determined the 1960 Mcf cost of new gas-well gas thus:

Exploration and Development Costs	
Dry Holes	1.42 cents
Other Exploratory Costs	1.59
Adjustments for Exploration in Excess of Production	1.11
Production Operating Expense	2.70
Net Liquid Credit	(3.10)
Regulatory Expense	.14
Depletion, Depreciation, and Amortization of Production Investment Costs	
Successful Well Costs	2.88
Lease Acquisition Costs	.76
Cost of Other Production Facilities	.31
Return of Production Investment (at 12%)	5.21[32]
Return on Working Capital	.35
Subtotal	13.37
Royalty at 12½ percent	2.05
Production Taxes	1.01
Total	16.43

[32] This is computed as follows: The production investment is the sum of successful well costs, lease acquisition costs, and cost of

The Commission rounded this figure off at 16.5 cents for the Texas production. Because the New Mexico figure is exclusive of taxes a reduction of one cent was made in the New Mexico price.

For the costing of flowing gas the Commission used historical data developed by the industry questionnaires. The results may be summarized thus:

Production operating expenses	1.75 cents
Depreciation, depletion and amortization	2.42
Return at 12%	4.99
Exploration and development	4.08
Regulatory expense	.14
	13.38
State Production tax at 7%	1.01
	14.39[33]

This figure was rounded off at 14.5 cents for Texas and 13.5 cents for New Mexico. As a check on the method used the Commission backtrended the new gas-well gas figures and arrived at a 14.64-cent price.

The rates so established are subject to downward adjustment because of quality deficiencies and to both downward and upward adjustments on the basis of Btu content. The Commission disclaims any intent that the rate figures show producer costs. It says that the price of new gas-well gas is "geared" to costs derived from national statistics and the questionnaire data and that for flowing gas

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other production facilities or a total of 3.95 cents. It is to be recouped over an average period of 10 years beginning an average of one year after investment. Accordingly, the return is allowed on an investment base 11 times the production investment of 3.95 cents per Mcf or 43.45 cents. 12% of this figure is 5.21 cents per Mcf.

[33] No separate item was included for royalty payments because costs were computed on 7/8 of actual volumes.

the "touchstone" is the historical price of Permian gas.[34] Other undefined and unidentified "factors" were taken into consideration.

9. **The Moratorium.**

The Commission implemented the price provisions of the decision in various ways. It imposed a moratorium on rate increases until January 1, 1968, "except in compliance with a specific order of the Commission for a rate as determined pursuant to said proceeding [AR61-1] or pursuant to later order of the Commission." The producers say this violates the Act because § 4 permits filings for rate increases. Section 4 must be read with other sections of the Act. Section 5 authorizes the Commission to determine the just and reasonable rate "to be thereafter observed and in force." Section 16 gives the Commission power to make such orders "as it may find necessary or appropriate to carry out the provisions of this act." In Callery the Court held that there was ample power under § 7(e) to impose a moratorium.[35] We believe that there is also ample power under §§ 5(a) and 16. The reasonableness of the exercise of the power is established by the need for price stability, the Commission's expressed willingness to reopen the proceedings to consider the propriety of changes, and the expiration date which is only about a year off.

10. **The Escalation Clauses.**

The Commission's order forbids the filing of rate changes in excess of applicable area rates when the contractual

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[34] In Opinion No. 468 the Commission said: "Nevertheless, we make clear that we do not confine ourselves to a cost calculation in determining just and reasonable rates."

[35] 382 U.S. 223, 228.

right thereto is based on indefinite escalation clauses not permitted by § 154.93(a), (b), and (c) of the Regulations under the Natural Gas Act. The producers say that this provision destroys existing contract rights. The Commission replies that it has not proscribed the clauses but merely the right to file under them. This is a thin distinction. In Pan American Petroleum Corporation v. Federal Power Commission, 10 Cir., 352 F. 2d 241, 245, we upheld § 154.93 and pointed out that if a producer felt aggrieved thereby it could apply for a rule waiver under § 1.7(b) of the Commission's Rules of Practice and Procedure. We assume that a similar request could be made under the Permian order. When the request is made and rejected, the time will arrive for the consideration of the constitutional questions which the producers raise.

11. **The Commission's Fair Relationship Standard.**

In fixing the amounts of the area rates the Commission rejected the end result test and adopted a fair relationship standard. This appears clearly from Opinion No. 468-A. After disclaiming that it had made any finding that "jurisdictional revenues will equate to jurisdictional costs," the Commission said:

> "* * * we are convinced that the record fully justifies the Commission's judgment that the ceiling prices we have fixed 'provide a fair relationship between the aggregate price the consumer pays and the aggregate costs that the producers incur' in the Permian Basin."

Hope says that in the fixing of just and reasonable rates there must be a "balancing of the investor and the consumer interests."[36] It goes on to say that from the company point of view the revenue must not only provide operation expense but also capital costs including "service on the debt and

[36] 320 U.S. 591, 603.

dividends on the stock"; and that the return to the equity owner must be commensurate "with returns on investments in other enterprises having corresponding risks" and "sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital."[37] The Court concluded the discussion of this problem with the observation that in Hope the "end result" could not be condemned as unjust and unreasonable.

In Colorado Interstate Gas Co. v. Federal Power Commission, 324 U.S. 581, 605, the Court, after referring to the Natural and Hope decisions said:

> "In those cases we held that the question for the courts when a rate order is challenged is whether the order viewed in its entirety and measured by its end results meets the requirements of the Act."

Also pertinent is the statement of the Court in Second Phillips that:[38]

> "To whatever extent the matter of costs may be a requisite element in rate regulation, we have no indication that the area method will fall short of statutory or constitutional standards. The Commission has stated in its opinion in this proceeding that the goal is to have rates based on the 'reasonable financial requirements of the industry' in each production area, * * * and we were advised at oral argument that composite cost-of-service data will be considered in the area rate proceedings."

Nothing in Second Phillips rejects the end result test of Hope. We believe that it applies here and that it is not satisfied by a finding of fair relationship. Something more than mere semantics is involved. The determination of a

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[37] Ibid.

[38] 373 U.S. 294, 309-310.

fair rate from the standpoint of the consumers must depend to large extent on the informed judgment of the regulatory agency. In these proceedings no distributor, consumer interest, or consumer representative objects to the rates. They are accepted as just and reasonable.

From the standpoint of the producer the situation is different. It is entitled to recover its prudent operating expenses and capital costs with a return commensurate to the risk and sufficient to attract capital. These requirements must be tested against the record. They may not be brushed aside with a general finding of fair relationship. The Commission concedes that it did not equate jurisdictional costs to jurisdictional revenues. This is obvious because no determination was made of the jurisdictional revenues which the rates will produce.

12. **The High Cost Operator and the Small Producer.**

The Commission broke down the rates into components which it justified on averages based on national statistics and questionnaire data. We recognize that weighted averages and sifted averages are suspect.[39] We accept the principle that both the basic figures and the averages obtained therefrom must be typical and representative but we are not convinced that the Commission has misused its expertise in this technical field. It is self-evident that when average costs are used to compute ceiling prices, the high cost operator will be hurt and some low cost operators may receive windfalls. Probably to a greater extent than in any other comparable segment of the national economy the element of chance can affect the success or failure of even the most prudent entrepreneur who engages in the natural-gas business.

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[39] See United States v. Abilene & Southern Railway Company, 265 U.S. 274, 291, and Interstate Commerce Commission v. Mechling, 330 U.S. 567, 583.

The problem of the high cost operator is characteristic of group or area rate making. The Supreme Court upheld group rates in Acker v. United States, 298 U.S. 426, 431, and commented that "regulation cannot be frustrated by a requirement that the rate be made to compensate extravagant or unnecessary costs." In Tagg Brothers v. United States, D.C. Neb. 29 F. 2d 750, 755, affirmed 280 U.S. 420, the court said that it was not necessary "to fix the rates so high that all agencies in the business would make money." Covington & Lexington Turnpike Road Company v. Sanford, 164 U.S. 578, 596, says that "the public cannot properly be subjected to unreasonable rates in order simply that stockholders may earn dividends."

The small producers, represented here by Big Chief Drilling Company, IPAA, Texas Independent Producers & Royalty Owners Association (TIPRO), J. C. Barnes, and others, join in the prediction that the Permian decision sounds the death knell of the small producers. Perhaps the flamboyant wildcatter must be replaced by the scientists of the industrial giants but the efforts of the boom-or-bust adventurers have contributed greatly to natural-gas discoveries. In its decision the Commission referred to the "smaller independent who traditionally drills much of the Permian exploratory acreage" and said that: "Consumers and the natural gas industry alike have a strong stake in the continuation of the exploration efforts of the thousands of small operators who contribute a large share of the discoveries of new sources of gas."[40]

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[40] Big Chief asserts that the small producers, although credited with only 20% of current production volumes, actually drill almost 40% of all successful gas wells and 50% of all successful exploratory gas wells.

The Commission took note of the suggestions that small producers should be exempt from regulation.[41] It found that outright exemption was neither necessary nor desirable but said that the small producers needed "special treatment." To this end it defined a small producer as "a natural gas company selling jurisdictionaly less than 10,000,000 Mcf annually on a nation-wide basis." They were granted relief from various requirements of §§ 7 and 4 and were freed from rate adjustments because of quality differentials. In our opinion the classification is reasonable and within the Act.

The small producers do not seek complete exemption. Their attitude is that such relief would be illusory rather than real because the pipelines would not pay more for gas supplied by them than the price paid to the major companies. Their complaint is that the Commission did not give adequate consideration to small producers' costs.

Data covering the costs of Permian producers came from questionnaires which are classified as Appendix B and Appendix C. The Appendix B group was mandatory for producers with company-wide jurisdictional sales of over 10 million Mcf and optional for others.[42] The Appendix C questionnaires went to the small producers. Forty-two of the majors and 25 of the small producers answered Appendix B. The response to the Appendix C questionnaires was sporadic. The Commission used only the material supplied by the majors saying that the inclusion of the data supplied by the small producers "does not affect the results."

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[41] See statements of Justice Clark dissenting in Second Phillips, 373 U.S. 294, 329-330, and speaking for the Court in Federal Power Commission v. Hunt, 376 U.S. 515, 527.

[42] Appendix A pertained to well and drilling statistics. It is not pertinent here.

TIPRO and Big Chief both emphasize the testimony of a staff witness that the small producer questionnaire showed average unit costs 2 cents per Mcf higher than those of the majors. They argue that the end result standards must be applied not only to the entire group but to them as a group. The weakness of the argument is that once the whole group is split the process can be carried on until the regulation is back on an individual company basis.

We do not know the answer to the small producer problem. Superficially it seems unfair to fix ceiling prices for all producers, both large and small, on the basis of the costs of large producers only. The Commission rejected the small producer data because in its opinion the impact on the rate structure was de minimis. On the record presented, we are unwilling to say that this conclusion was erroneous as a matter of law.

In any regulation of the natural-gas industry on an area basis the high cost producers, be they majors or little fellows, are certain to be placed in a position less advantageous than that occupied by those whose good fortune and able management have supplied a lower cost base. We agree with the Commission that the expense items included in an individual cost-of-service are not the measure of a confiscatory rate. A producer has no constitutional right to be reimbursed for dry-hole expenses.[43] Also it has no obligation to remain in business by replenishing the supplies of gas which form the basis of present obligations. Inability to continue exploration and development is not confiscation. We conclude that the impact of the Permian rates on the high cost producers does not destroy the area rate method.

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[43] Cf. Columbus Gas & Fuel Co. v. Public Utilities Commission of Ohio, 292 U.S. 398, 407.

13. **Gathering and Processing Costs.**

One subject of much discussion in the briefs is the allowance of the same rate for gas delivered at the tailgate of a processing plant and for gas delivered at the wellhead. Gathering lines cost money and have to be built and operated by someone. The Commission's position is that the revenues received for oil and oil products derived from condensation and processing return a profit which induces the building of the needed gathering lines and plants. Here again we reach the troublesome field of cost allocations between a regulated commodity, gas, and unregulated commodities, oil and liquified petroleum products.

Bass places particular emphasis on this phase of the case. It points to its extensive investments in gathering lines and plants and to its permanently certificated rate of 18 cents which, it says, the Commission has never specifically found unreasonable or discriminatory. The answer as we see it is that if area rates are proper no greater need exists for the consideration of the individual cost and revenue requirements in the case of Bass than in the case of the other producers. Perhaps in the future courts will have to explore the mysteries of allocations but we are not so inclined in this case. If in fact Bass and others similarly situated are confronted with confiscation, a way must be open for them to be heard.

14. **Special Exemptions.**

The Commission recognized that some provision must be made for special exemption from area rates. It said that when a producer's "out-of-pocket expenses in connection with the operation of a particular well are greater than the revenues under the applicable area price, he should be entitled to appropriate relief." It declined to "specify

all of the special circumstances which may serve as a basis for exceptions to the area rate" and observed that failure to earn exploration and development expenses plus the allowed return does not amount to confiscation. In regard to the form of relief it held that "it may be sufficient to permit them to abandon their unprofitable sales."

We agree with the Commission that an escape clause cannot be used to convert an area rate into an individual company cost-of-service rate but an escape clause which does no more than prevent an unconstitutional confiscation amounts to nothing. None is needed for that purpose. The producers are right in saying that the Commission's exemption provisions are so vague and nebulous that neither they nor a court can determine what relief is being granted. Out-of-pocket expenses are not defined and we do not know what they include. If a producer's accounting is on a lease rather than well basis, the facts relating to a particular well might not be determinable. It may be going too far to say categorically that individual producers should be permitted to show that the group costs are not typical or representative of their costs but in some instances that should be permitted. Conservation of gas is promoted if marginal wells are allowed to continue to produce but is discouraged if the same wells are shut down by a low price. Some producers furnish gathering facilities. Others sell at the wellhead and the pipelines pay for the gathering. Gathering costs are allowed pipelines. Perhaps in some instances they should be allowed to producers. An adequate savings clause should contain guidelines which if followed by an aggrieved producer will permit it to be heard promptly and to have a stay of the general rate order until its claim for exemption is decided. It is not enough to say in effect that confiscation will be prevented. Confiscation is an individual proposition and the individual is entitled

to be heard. We are convinced that the Commission's special exemption provisions are inadequate.

15. **Quality Standards.**

The Commission provided for adjustments in the area rates to reflect quality differentials. It said that "the price of gas cannot be related to volume alone but must be related to units of energy free of impurities and sufficiently compressed to enter the pipeline." Standards were fixed for content of carbon dioxide, hydrogen sulphide, total sulphur, water, and other impurities; and the amount of delivery pressure was established. The applicable base area rate is adjusted downward by the net cost of processing the gas to bring it up to standard. Provision is made for both an upward and a downward adjustment of rate depending on the Btu content. Quality statements are required to be filed together with an agreement by the seller and the buyer covering the cost of bringing the gas up to standard. If an agreement cannot be reached, each shall file a statement of its views on the processing costs.

About 90% of the flowing gas is substandard. We are cited to no figures on the similar percentage of new gas-well gas. The amount of the rate adjustments does not appear in the record because there was no evidence of the extent of quality differentials or of the processing costs of bringing the gas up to standard.[44] At oral argument various estimates were given as to the amount of rate reduction which would result from substandard quality. These were based on statements filed pursuant to the decision but after the record was closed. They ranged from .7 cents to 2.0 cents per Mcf. A spokesman for the Continental

[44] The Commission says in its brief that "appropriate price differentials or adjustments could not be made on the basis of the record."

Group said that on 1960 volumes a revenue deficiency of some $12 million a year would result. The Commission response in this court to the Skelly motion for stay of the Commission's orders herein said that the reductions in applicable rates because of adjustments for quality standards are expected to result in a revenue reduction of about $10 million annually.[45]

The producers' argument that the imposition of quality standards violates procedural due process because of lack of notice need not be resolved at this time. We are remanding the case and now everyone has notice. The matter of the Btu adjustments presents a particular problem which was emphasized by Commissioner O'Connor in his dissent. The price goes down if the Btu content is below 1,000 and goes up if it is above 1,050. The producers say the adjustment upward should begin at 1,000. We do not understand the Commission's reasons for the gap. On remand this can be clarified.

16. **The Rate of Return.**

The Commission says that the impact of the quality adjustments is taken care of in the rate of return which is made generous on this account. It fixed a rate of return of 12% on production activities and held that such rate "protects gas consumers against excessive prices but it is not so low that it fails to respond to the needs of the industry." The principles applicable to the determination of an appropriate return are set forth in Bluefield Water Works & Improvement Co. v. Public Service Commission, 262

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[45] The statement was this: "It has been estimated that the reductions to the base rates alone will reduce the revenues from jurisdictional Permian sales by about $10 million annually. The adjustments for quality standards, which were substantially altered by Opinion 468-A * * * are expected to result in a further reduction of the same magnitude."

U.S. 679, 692-693. It "must be determined by the exercise of a fair and enlightened judgment, having regard to all relevant facts." The rates of a public utility should "permit it to earn a return on the value of the property * * * equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties" but the utility has no constitutional right to profits realized by "highly profitable enterprises or speculative ventures." The return should assure "confidence in the financial soundness of the utility" and be adequate under prudent management "to maintain and support its credit ad enable it to raise the money necessary for the proper discharge of its public duties." The Hope decision[46] states the same basic principles.

The Commission recognized these controlling principles. The objections of the producers are to the point that the allowed rate of return is inadequate to enable the industry to attain the goals which the principles contemplate. At this time there is no need for us to go into the comparisons of the returns appropriate for producers as opposed to pipelines or to the financing methods employed by either. The fact is that by treating quality deductions as a risk rather than a cost the Commission has made it impossible to determine the amount of return with any degree of certainty. The difficulty is that the record does not disclose the amount of deductions.

A fair rate of return cannot be ascertained with mathematical certainty.[47] Pragmatic adjustments may be made by an agency within the ambit of its statutory authority.[48]

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[46] 320 U.S. 591, 603.

[47] Colorado Interstate Gas Co. v. Federal Power Commission, 10 Cir., 142 F. 2d 943, 961-962, affirmed 324 U.S. 581.

[48] Federal Power Commission v. Natural Gas Pipeline Co., 315 U.S. 575, 586.

A court must put great reliance on agency expertise in evaluating a rate of return but this does not mean that a court must accept the agency determination in blind faith. A producer is entitled to a higher rate of return than a pipeline because of the greater risk of the business. The Commission has here compounded the risk of discovery with the risk of substandard quality.

We believe that the price reductions to reflect quality deviations are an item of cost rather than an item of risk and should be directly reflected in the applicable base rates instead of hidden in a rate of return allowance. The amount of cost is the expense of bringing the quality up to standard. In the Permian Basin sound reason exists for this conclusion because of the known and substantial quality deficiencies particularly in flowing gas production. We find it hard to understand why a revenue deficiency in the estimated amount of $10 million annually should be classified as a risk and not a cost. A risk occurs as the result of unknown or unconsidered contingencies. In the Permian Basin it is known and considered that flowing gas falls short of pipeline standards. In any event, the lack of evidence as to quality deductions makes it impossible to determine whether the rate of return satisfies the Bluefield and Hope principles and we have no basis on which to appraise the allowance made by the Commission. We respect the expertise of the Commission but the conclusions reached by the use of expertise must accord with legal standards.

17. Contract Limitations.

The producers say that recovery of industry costs under the area rates is impossible because many of the existing contracts do not permit a producer to file for the flowing gas ceiling price of 14.5 cents. The Commission recognized that "there undoubtedly will be some contract prices

lower than the area rate ceiling, as adjusted for quality." Some of the producers estimate the deficiency because of contract limitations to be $14.4 million in the test year of 1960. The Commission has estimated that a reduction of base rates alone will result in a revenue reduction of about $10 million annually.[49]

It is elementary that gas prices are originally set by contract between the producer and the pipeline, that the producer may not raise the price unilaterally, and that any increase in price must be within contract terms unless the price is set so low as to affect the public interest. The Commission says that the producers are not entitled as a matter of right to collect contract rates that are higher than otherwise reasonable in order to offset other rates limited by contract to below maximum reasonable levels. Regulation does not guarantee an over-all profit;[50] relief from an unduly low rate may be given only if the rate is "so low as to adversely affect the public interest — as where it might impair the financial ability of the public utility to continue its service, cast upon other consumers an excessive burden, or be unduly discriminatory";[51] and a company's losses in one instance do not justify an illegal gain in another instance.[52] At the same time in such group procedures as the division of railroad rates the Interstate Commerce Commission, with court approval, has recognized that revenue from one source may balance that from another.[53]

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[49] See supra, note 45.

[50] Federal Power Commission v. Natural Gas Pipeline Co., 315 U.S. 575, 590.

[51] Federal Power Commission v. Sierra Pacific Power Co., 350 U.S. 348, 355.

[52] Federal Power Commission v. Tennessee Gas Transmission Co., 371 U.S. 145, 153.

[53] See New England Divisions Case, 261 U.S. 184.

Contract limitations are one of the facts of life for the natural-gas industry. They are the outgrowth of the days when gas, which had previously been vented, flared, or capped, became salable to the newly constructed interstate pipelines. The pipelines wanted long-term contracts and the producers wanted to sell their gas. Prices were low. With the phenomenal increase in the use of gas as an energy source the prices rose. The producers whose contracts either contained no escalation clauses or clauses of the type proscribed by the Commission were in a disadvantageous position. Even permissible escalations do not, in many instances, bring the 1960 price up to the area ceiling. In Second Phillips the Court upheld the termination of certain § 4(e) dockets on the Commission's finding that "the annual increase in revenue produced by these increased rates was substantially less than the deficit for the test year 1954."[54] The same situation exists here for many companies. We do not know whether it exists for the area producers as a group because no finding was made of revenue and requirements. The Supreme Court has said that losses in one instance do not justify illegal gains in another. To us this means that the contract limitations do not preclude the establishment of a just and reasonable area rate. The answer is provision for a minimum rate.

The Commission held that "the establishment of minimum rates in this case is in the public interest and that the price impact on the consumer will be de minimis." It established a minimum rate of 9 cents per Mcf for gas of standard pipeline quality. We believe that the controlling question is whether the proper revenue requirements of the area producers as a group can be satisfied with rates having the ceiling and the floor which the Commission has fixed.

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[54] 373 U.S. 294, 305.

This cannot be answered because the financial impact of the quality deductions is not ascertainable from the record.

18. **Refunds.**

The revenue deficiency argument of the producers leads directly to the refund issue. The Commission required "appropriate refunds in the case of rates which are the subject of proceedings under Section 4(e) of the Act, and have thus been collected subject to an obligation to refund amounts collected in excess of the just and reasonable rates as here determined." Procedures to accomplish this result were set up in detail.

The producers say that these individual company refunds are not proper because of the revenue deficiency of the industry. They say that in the test year of 1960 the producers in the area failed to meet their revenue requirements by $14.4 million and they estimate the refunds for that year under the Commission decision to approximate $6 million.

The Examiner held that refunds should be ordered only to the extent that over-all industry revenues exceed over-all industry expenditures in a given year. The Commission said that this theory was unworkable because it would result in inequities among both the buyers and the producers and because of "insurmountable" administrative difficulties. We are at a loss to understand how refund obligations, which might come into existence under the Examiner's approach, would be divided among the producers.

We see no escape from the requirement that refunds be on an individual company basis and on a schedule by-schedule basis. As we understand Federal Power Commission v. Tennessee Gas Transmission Co., 371 U.S. 145, 153, refunds are appropriate for each excessive rate re-

gardless of over-all revenues. The Commission has required refunds only on § 4(e) rate increases above the applicable area ceiling. If a producer claims that the refunds required of it are confiscatory or harmful to the public interest, it must have an opportunity to petition for special relief. A similar opportunity must be afforded if a producer can show that a refund is required for collections at or below the "last clean rate."[55] An adequate special exemption clause can take care of such situations.

19. **The End Result Test.**

This brings us back to the end result test. The Continental Group, which includes many large producers and major integrated oil companies and which is supported by Phillips, presents alternative arguments. The first is economic. It is said that regulation under the Act must be consistent with the economic characteristics of the industry; that this requires the establishment of market prices based on contracts; that a cost-based system of regulatory rates does not recognize the responsiveness of the gas supply to gas prices; and that a producer does not explore on the expectation of a return of its cost plus a return on its investment but on the hope of getting back many times what it expends as a reward for its gambler's risk. No doubt these are the economic facts of the industry.

The divorce of commodity value from costs was suggested by Justice Jackson in his dissent in Hope. He commented that a producer would have difficulty showing the invalidity of a fixed commodity value so long as it voluntarily continued to sell its product in interstate commerce.[56] One difficulty with this suggestion is that once the gas is

[55] By "last clean rate" is meant the last rate in effect pursuant to a permanent certificate not subject to any refund obligation.

[56] 320 U.S. 591, 652.

committed no withdrawal from interstate movement is possible without Commission approval.[57] A producer can stop exploration and development if it is dissatisfied with price but the interstate sales go on with a continuing impact of cost on price and of price on exploration and development. In any event the majority rejected the proposal and held that under the just and reasonable standard of the Act a regulated company is entitled to revenue for operating expenses and capital costs and to a return "commensurate with returns on investments in other enterprises having corresponding risks."[58] These standards cannot be met without consideration of costs and revenues. In our opinion the Hope construction of the statutory standard casts serious doubts on the validity of the adoption of a contract-based commodity value.

The alternate argument of the Continental Group is that if the rates are to be determined on a composite cost-of-service basis, the revenue requirements of the industry must be found and rates fixed to meet those requirements. In Second Phillips the Court particularly noted the assurance of the Commission that "composite cost-of-service data will be considered in the area rate proceedings."[59] Consideration of such data does not eliminate consideration of other factors. At the same time Second Phillips did not reject the end result test of Hope. Instead it quoted a portion of that opinion which said among other things that "it is the result reached not the method employed which is controlling."[60]

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[57] Section 7(b) of the Act. See also Sunray Mid-Continent Oil Co. v. Federal Power Commission, 364 U.S. 137, 156.

[58] 320 U.S. 591, 603.

[59] 373 U.S. 294, 310.

[60] Id. at 309.

The Commission rejected both alternatives of the Continental Group. It said that commodity value established by contracts may not be used because of the absence of effective competition; and it emphasized that it took into consideration factors other than costs. The record does not disclose what these other factors were but they must have had some economic basis. The Commission held that its ceiling prices provided a "fair relationship" between consumer prices and producer costs. Fair relationship is pertinent but it is only part of the end result test. We do not know the producers' costs or revenue requirements. We do not know the economic factors which either require or permit departure from costs and revenues. The end result test is not satisfied by a reliance on unknowns.

We have accepted the Commission's conclusion that contract rates should not be used. The trouble is that the Commission decision rides two horses and we have no way of knowing the outcome of the race. It uses composite cost-of-service evidence, engrafts economic factors on top, and comes out with a rate which it justifies on a fair relationship basis. We have the problem of how in such circumstances a court can determine whether the just and reasonable standard of §§ 4 and 5 has been met. The answer is not found in the record before us.

The facts sustaining the conclusion of fair relationship must be found. The Commission did not make those findings and indeed it could not have done so because of the failure of the record to disclose the revenue impact of the adjustments in area rates to reflect quality differentials. Whether rate reductions because of quality deficiencies are a risk or a cost, the answer comes out the same. If they are a risk, we do not know the rate of return. If they are a cost, we do not know whether revenue received will equal the reasonable revenue requirements. We believe

that under Hope, and under Second Phillips, the area producers, as a group, are entitled to recover their prudent operating expenses and capital costs with a return commensurate to the risk and sufficient to attract capital. Satisfaction of this requirement must appear through appropriate findings based on substantial evidence. These cannot be made on the record presented. The decision of the Commission is not saved by the special exemption provisions which we find to be insufficient and unsatisfactory.

Rate making under the Act has produced a superabundance of delay and litigation. Much gas has moved through the pipelines since the First Phillips decision. We wonder if the time has not come for the establishmnt of a better rapport among the Commission, the consumers, the distributors, the pipelines, and the producers. Some practical means of resolving the economic and legal issues is highly desirable. The Commission has approved many settlements. The use of this procedure may well be explored further in an effort to obtain a true "balancing of the investor and the consumer interests."[61]

One point remains to be mentioned. Eleven motions for leave to adduce additional evidence were filed with us by various producers. We deferred all to the hearing on the merits. In view of the disposition which we make of the cases we see no reasons to explore evidentiary problems which may arise on remand. The Commission will hold such additional hearings as are needed to determine the effect of the quality adjustments, and to determine the group revenues and the group revenue requirements. It will make appropriate findings on these matters. The order based thereon shall contain an adequate provision for special ex-

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[61] 320 U.S. 591, 603.

emptions. We decline to make advance rulings on the procedures to be followed or on the evidence to be received.

The motions to adduce additional evidence are severally denied. The petitions to review are severally granted and the cases are all remanded to the Commission for further proceedings consistent with this opinion.

APPENDIX B

JUDGMENT*

THIRTEENTH DAY, JANUARY TERM,
FRIDAY, JANUARY 20TH, 1967.

Before Honorable David T. Lewis, Honorable Jean S. Breitenstein and Honorable Delmas C. Hill, Circuit Judges.

No. 8493

CONTINENTAL OIL COMPANY, ET AL.,
Petitioners,

v.

FEDERAL POWER COMMISSION,
Respondent.

On Petition to Review an Order of the Federal Power Commission.

This cause came on to be heard on petition to review an order of the Federal Power Commission and motion to adduce additional evidence and was argued by counsel.

On consideration whereof, it is ordered by this court that the motion to adduce additional evidence is hereby denied. The petition to review is granted and the case is remanded to the Commission for further proceedings consistent with the opinion of the court.

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* An identical judgment was entered in Tenth Circuit Cause No. 8505, Midhurst Oil Corporation v. Federal Power Commission. Midhurst Oil Corporation is also petitioner with Continental Oil Company in Cause No. 8493.

PETITION FOR A WRIT OF CERTIORARI

FILED
APR 18 1967
JOHN F. DAVIS, CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM 1966

No. [redacted] 95

THE SUPERIOR OIL COMPANY,
Petitioner,

v.

FEDERAL POWER COMMISSION,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

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OCTOBER TERM 1966

No. .....

THE SUPERIOR OIL COMPANY,

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FEDERAL POWER COMMISSION,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

The Superior Oil Company, Petitioner, prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Tenth Circuit entered in the above entitled case, *sub nom Skelly Oil Company, et al.*, Petitioners, v. *Federal Power Commission,* Respondent, Nos. 8385, *et al.* [No. 8510], on January 20, 1967. Other than the named Respondent, adverse parties hereto are The State of California, Public Utilities Commission of the State of California, City of Los Angeles, City of San Diego, City and County of San Francisco, Pacific Gas and Electric Company, Pacific Lighting Service and Supply Company, Southern California Gas Company, Southern Counties Gas Company of California, and San Diego Gas and Electric Company.

OPINIONS BELOW

The opinion of the Court of Appeals for the Tenth Circuit, *sub nom Skelly Oil Company, et al.,* Petitioners, v. *Federal Power Commission,* Respondent, Nos. 8385, *et al.* [No. 8510], is not yet officially reported. Said opinion is set forth in Appendix "B" hereto, P. 9a to 60a. The opinion and orders of the Federal Power Commission herein styled *Area Rate Proceeding, Docket Nos. AR61-1, et al.,* are reported at 34 FPC 159, with denials of rehearing and modifications at 34 FPC 1068, 1082, 1198, shown in the Joint Appendix (JA) printed for the use of the court below as follows: JA 277,554-277,800; 278,704-278,726; and 278,756-278,757.

JURISDICTION

The judgment of the Court of Appeals was entered January 20, 1967. Certain petitions for rehearing have been filed with that court and are now pending before it; however, they do not raise the issues here presented and their disposition will not affect this Petition. Jurisdiction of this Court is invoked under 28 U.S.C. Sec. 1254(1) and Section 19(b) of the *Natural Gas Act,* 15 U.S.C. 717r(b).

QUESTIONS PRESENTED

1. **Is there a constitutional or statutory bar to determination of just and reasonable rates for a natural gas company under the Natural Gas Act on the basis of group composited costs?**

2. **If the Natural Gas Act permits the fixing of rates for a natural gas company on the basis of composite cost determination for a group, does it not violate Art. I, Sec. 1, of the Constitution of the United States in that it fails to provide any standard whatsoever for the make-up of such group?**

3. **Where the regulatory agency without evidence or hearing selects a group of natural gas companies for regulation of the rates of each on the basis of group composite cost, and precludes any contention that the group selected may be inappropriate for such purpose, is not a natural gas company aggrieved by the rate so fixed for it deprived of due process of law under the Fifth Amendment to the Constitution?**

4. **Does a gas producer, regulated as a natural gas company under the Natural Gas Act, have a constitutional and statutory right to be reimbursed for all expenses, including dry hole expenses reasonably incurred in finding and producing natural gas sold subject to said act?**

CONSTITUTIONAL PROVISIONS AND STATUTES INVOLVED

The Constitutional provisions involved are Art. I, Sec. 1, of the *Constitution,* and the *Fifth Amendment to the Constitution,* The statute involved is the *Natural Gas Act,* June 21, 1938, c. 556, 52 Stat. 821-833, as amended, 15 U.S.C. 717-717w, and particularly Sections 2, 4, 5, 7 and 16 thereof. The pertinent portions of the respective provisions of the Constitution and the statute are set forth in Appendix "A" hereof.

STATEMENT OF THE CASE

This case presents for review questions decided by the Federal Power Commission (JA 277,567-277,755; 278,704-278,726; 278,754-278,757) arising under the *Natural Gas Act* (Act) as amended. Judicial review of the Commission order has been had under Section 19(b) of said *Act* before the Tenth Circuit Court of Appeals, Appendix "B", P. 9a et seq hereof.

This proceeding represents the Commission's first attempt at group rate fixing under said Act and presents for the first time this Court's opportunity for review of such effort. The companies selected for regulation as a group included all natural gas companies classified as independent producers under said *Act* making jurisdictional sales within any part of the so-called Permian Basin Area.

The geographical area, the so-called Permian Basin Area, encompassed separate pricing areas delineated in the *Commission's Statement of General Policy 61-1,* 24 FPC 818. It included (1) the so-called Permian Basin Area of New Mexico — three entire counties; (2) that in Texas Railroad Commission District 7-C — fourteen entire counties; and (3) that in Texas Railroad Commission District No. 8 — forty-one entire counties. The Policy Statement had recognized that the areas there established might ultimately be found inappropriate as pricing areas, 24 FPC 818, 819, although the guideline prices announced for the separate areas were the same.

The Commission order invoking this hearing specifically provided that issues or contentions that the geographical area selected, and the resulting group composition, were not appropriate for group rate making purposes would not be entertained because such consideration might delay the final determination of rates. Order issued December 23, 1960, (JA 268,203 at 268,204).

By subsequent Order of August 2, 1961 (JA 270,235-270,240) as amended January 11, 1962 (JA 273,253-273,255), the Commission directed Respondents to complete and submit certain data forms, i. e. Appendix A — "Operating Data" (all Respondents); Appendix B — "Cost and Statistics Pertaining to Oil and Gas Production, Exploration, Gas Gathering and Products Extraction Operations Year 1960"

(Respondents with companywide jurisdictional sales of 10 Million Mcf or more); and Appendix C—"Costs and Statistics Pertaining to Oil and Gas Production and Exploration—Small Producers, Year 1960", a simplified form of Appendix B as to which Respondents with companywide jurisdictional sales of less than 10 Million Mcf for 1960 might elect between "B" and "C". Order of April 5, 1961 (JA 269,877 at 269,879) specifically ruled that rate base cost of service studies for individual producers or groups of producers could not be introduced in evidence in this proceeding. See also Order of August 2, 1961 (JA 270,235 at 270,237) and Examiner's Opinion at JA 29,361-29,363. Compositing of the data from Appendices A, B and C was handled by Commission Staff[1] and the composited data was the "bedrock" for the rates here established, although other factors, such as need for a rate sufficient to elicit adequate exploration, and avoidance of abrupt departure from existing pricing patterns, if possible, were considered. (JA 277,602-277,603)

The Commission held that while Section 4(a) of the Act requires that all rates and charges of *any* natural gas company shall be just and reasonable, nothing in the Act states or suggests that such rates cannot be determined in a group or on an area basis rather than in individual proceedings; (JA 277,579), that constitutional restrictions and statutory powers should be considered in the light of the particular problem and what is necessary for a "sensible" result; (JA 277,581), that rates based on individual cost experience could be either too high for consumers in relation to other

[1] 361 Appendices A and B were mailed out, and approximately the same number of Appendix C. There were 249 responses to Appendix A, of which 220 were included in Commission Staff exhibits; 68 responses to Appendix B of which data from 67 were employed by Staff; and 105 responses to Appendix C of which data from 69 were used by Staff. (JA 274,576-274,578)

available supplies, or too low to be fair to the regulated producers considering their risks; that group cost based rates would be fair to all since profits in the aggregate would be at a reasonable level, although individual returns thereunder would vary greatly; (JA 277,582-3), other price regulatory acts do not require consideration of rates related to individual costs; (JA 277,579-277,581), and thus group rate fixing under this Act is legal.

The Court of Appeals affirmed the Commission on these matters. It acknowledged that a group fixed rate will establish rates which range from bonanza to bankruptcy for the several companies in the group but such effect was to be tolerated because of the actual necessities of procedure and administration here involved and must have been recognized as an inevitable result in *Wisconsin* v. *Phillips Petroleum Co.* (Second Phillips), Appendix "B", P. 32a hereof.

The court below held that no prior judicial decision had passed on the question of legality of group rate fixing under this *Act*,[2] but noted that group rate regulation had been sustained under other statutes.[3] The court assumed that the Congressional requirement for rate regulation must have intended use of a method by which that end could be attained and thus there was no abuse of discretion in here resorting to group price fixing since same was not specifi-

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[2] Appendix "B", P. 28a hereof, pointing out that *Wisconsin* v. *Phillips Petroleum* (Second Phillips), 373 U.S. 294, 83 S. Ct. 1266 (1963), did not reach it nor did *United Gas Improvement* v. *Callery Properties, Inc., et al.* (Callery), 382 U.S. 223, 225-226, 86 S. Ct. 360; and holding that while *Bowles* v. *Willingham*, 321 U.S. 503, 517, 64 S. Ct. 641 (1944), held that individual rate making was required by the Natural Gas Act, such was dicta, the value of which was destroyed by *Second Phillips*.

[3] Appendix "B" hereof, P. 29a-30a *Interstate Commerce Act*, 49 U.S.C. § 15; *Packers & Stockyards Act of 1921*, 7 U.S.C. 181, et seq.; *Agricultural Marketing Agreement of 1937*, 7 U.S.C. 601, et seq.; *Bituminous Coal Conservation Act of 1937*, 15 U.S.C. 828-851; and state acts for regulation of insurance rates and control of milk prices.

cally prohibited by the *Act* and there was no constitutional obstacle to such method.

The court below further held that although the language of the *Act* in all pertinent clauses provided for regulation in the singular, Appendix "B", P. 30a, and was entirely silent on group rate fixing, nevertheless it contained sufficiently definite standards to allow the Commission to select groups for rate making and was not subject to objection under Art. I, Sec. 1, of the *Constitution* as an unfettered delegation of legislative power, particularly since it was unconvinced that the Commission order precluding contest of the grouping for price regulation denied the producers any specific right. Appendix "B", P. 33a, 34a hereof.

The court also held that the end result of a just and reasonable rate established under the *Act* must be a rate that produces revenues sufficient to cover operating expense, capital costs, including service on the debt and dividends on the stock of the regulated enterprise with a return to the equity owner commensurate with that from investment in other enterprises with corresponding risks and sufficient to assure confidence in the financial integrity of the enterprise and maintenance of its credit and ability to attract capital. Appendix "B", P. 33a, 41a, 42a hereof. It reversed the Commission decision for failing to find that the group rate here established was sufficient to meet the above end result test for the group. Appendix "B", P. 42a hereof. The court held that expense items and dry hole expenses which might be included in an individual cost of service for determination of lawful rates was not the measure of a confiscatory rate because a gas producer has no obligation to remain in business or replenish its committed gas supply, and therefore the adverse impact of a group fixed rate on high cost producers, even though inevitable, does not de-

stroy the area or group rate fixing method. Appendix "B", P. 46a hereof.

The further holding of the court below on particular matters such as the impact of quality adjustment on revenues under the ceiling rate; the Btu "gap" in quality adjustment; the uncertainty of rate of return allowed; and the special exemption established by the Commission; all of which were found not adequately nor properly handled by the Commission for which remand was required, are here omitted as not pertinent to the questions posed.

REASONS FOR GRANTING THE WRIT

I.

The issues here involve a number of important questions arising under the *United States Constitution* as related to this new construction of the *Natural Gas Act*, 52 Stat. 821-833 as amended, 15 U.S.C. 717-717w, which have not been, but should be, settled by this Court. The method of future rate regulation of all independent producers as to their gas sales subject to the *Act* is at issue.

Independent producers of natural gas who sell same in interstate commerce for resale have been held to be natural gas companies under the *Act*. *Phillips Petroleum Co.* v. *Wisconsin* (First Phillips), 347 U. S. 672, 678, 74 S. Ct. 794, 796 (1954). The *Act* provides a single standard of rate regulation for all natural gas companies subject to its terms.

As the court below recognized, this Court has never passed on the legality of group rate making under this *Act*.[4]

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[4] *Second Phillips*, supra, expressly recognized that the matter was not there at issue, 373 U.S. 294, 308, 83 S. Ct. 1266, 1274 (1963):

> "The lawfulness of the area pricing methods are not themselves before the court for review", and further recognized the *right* of producers to a just and reasonable rate.

Every prior rate case under the *Act* has been based on findings that the rates therein established are just and reasonable for the particular natural gas company involved. The *Act*[5] condemns as unlawful rates for any natural gas company which are not just and reasonable and which are unduly discriminatory or preferential. Rates fixed by any regulatory method which provide a windfall for one or more producers at the expense of the bankruptcy of other producers appear unjust, unreasonable, unduly discriminatory and preferential on face value, and thus are prohibited by the Act.

In construing the *Act* to authorize group rate fixing Constitutional questions not present in proceedings determining rates on an individual basis are for the first time presented. It is respectfully submitted the court below has erroneously decided these questions.

Every pertinent section of the *Act* relating to rate regulation or certification of natural gas companies is couched in the singular number rather than the plural. This was recognized by the court below; notwithstanding it was held that since the *Act* did not in terms prohibit group rate fixing and the regulatory end sought could be most conveniently attained by such method, it was assumed to be permissible under *Sec. 16 of the Act,* Appendix "B", P. 31a, 33a hereof, permitting orders "necessary or appropriate to carry out the provisions" of the *Act.* This holding conflicts with the specific provision of Section 4(a) of the *Act* which requires that all rates of *any* natural gas company shall be just and

[4] (Cont)
"Surely, we cannot say that the rates to be developed in these [area] proceedings will in all likelihood be so high as to deprive consumers, or so low as to deprive producers, of their right to a just and reasonable rate." Id. P. 310, 1275; and *Callery,* supra, was a certificate case.

[5] Sections 4 and 5, Appendix "A", P. 2a-5a hereof.

reasonable, and that all other rates are unlawful. Violation of this unequivocal Congressional mandate is clear when it is conceded fact that the rates fixed by a group method will of necessity range from bonanza to bankruptcy for some companies affected. Such rates are either unreasonably high or unreasonably low for the particular members of the group and are not just and reasonable for any company in the group. The provision "any natural gas company" in common English means each and every natural gas company, or one indifferently out of a number. *Webster's New International Dictionary,* Second Edition, P. 121. See also *United States* v. *National City Lines,* 80 F. Suppl. 734, 741 (D.C. Calif. 1948).[6] Difficulty of administration in enforcing regulations under an act of Congress does not justify a procedural or administrative method which results in a violation of the Act itself. *National Labor Relations Board* v. *Brown,* 380 U. S. 278, 291, 292, 85 S. Ct. 980, 988 (1956). Furthermore, "The deference owed to an expert tribunal cannot be allowed to slip into a judicial inertia which results in the unauthorized assumption by an agency of major policy decisions properly made by Congress." *American Shipbuilding Co.* v. *N.L.R.B.,* 380 U. S. 300, 318, 85 S. Ct. 955, 967 (1956).[7]

The construction of the *Natural Gas Act* is not an open matter. It has been held constitutional on the ground that its standard for rate regulation — just and reasonable rates, not unduly discriminatory nor preferential — coincides with

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[6] Cf. Here a statute, not the broad terms of a Constitution is involved. *Addison* v. *Holly Hill Fruit Products, Inc.,* 322 U.S. 607, 617; 64 S. Ct. 1215, 1221 (1944).

[7] Cf. *Social Security Board* v. *Nierotko,* 327 U.S. 358, 369, 66 S. Ct. 637, 643 (1946).
East Texas Motor Freight Lines, Inc. v. *Frozen Food Express,* 351 U.S. 49, 54, 76 S. Ct. 574, 577-578 (1956).
C.A.B. v. *Delta Air Lines, Inc.,* 367 U.S. 316, 322, 81 S. Ct. 1611, 1617 (1961).

the requirements of the Fifth Amendment to the *Constitution, Federal Power Commission* v. *Natural Gas Pipeline Company of America, et al.* (Natural), 315 U. S. 575, 62 S. Ct. 736, because in fact the lowest reasonable rate is a non-confiscatory rate. In *Federal Power Commission* v. *Hope Natural Gas Co.* (Hope), 320 U. S. 591, 64 S. Ct. 281, it was held that the Commission was not bound to use any single method of rate regulation but that whatever method chosen must yield as an end result a rate that is just and reasonable. Furthermore, to be just and reasonable it was held there must be a "balancing of the investor and consumer interest" in fixing the rate, and from "the company point of view" the rate must provide revenues sufficient to cover operating expenses, capital costs, and return on the investment sufficient for the enterprise to maintain credit and attract capital. The investor has a "legitimate concern" in the financial integrity of the company regulated, *Hope, supra* at P. 603. See also *Colorado Interstate Gas Co.* v. *Federal Power Commission,* (Colorado Interstate), 324 U. S. 581, 65 S. Ct. 829 (1945). The rule of *Hope* was reannounced by this Court in *Wisconsin* v. *Federal Power Commission* (Second Phillips), 373 U. S. 294, 83 S. Ct. 1266. There, considering the very proceeding here involved as a proposal only, the Court said it would not assume that any rate resulting would "be so high as to deprive consumers, or so low as to deprive producers of their right to a just and reasonable rate", id. at P. 310. A group fixed rate deprives both consumers and producers of the *right* to a just and reasonable rate provided for by Sec. 4 of the *Act* and guaranteed by the Constitution. Appendix "A", P. 1a, 2a hereof. The consumers served by the producer with the bonanza return pay an unreasonably high rate; on the other hand the producer with the bankruptcy rate has his property confiscated. The result this Court refused to assume would occur in its *Second Phillips* opinion has in fact occurred.

Resort to group rate fixing eliminates from the *Act* the only standard it contains for rate regulation. Such method obliterates entirely "a company point of view" for determination of whether the end result of the rate is just and reasonable. It becomes impossible to determine the legitimate interests of the investors in a regulated company or to assure that confidence in such a company's financial integrity is preserved. Investors exist only in companies, not groups of companies. Certainly no separate enterprise in a group has financial integrity simply because another enterprise in the same group is obtaining a bonanza rate.

II.

Recognition that the *Act* makes no provision for group rate fixing, *a fortiori,* concedes the total lack of any standard for the selection of groups for regulation. Thus, if construed to authorize group rate regulation, the *Act* itself is contrary to Art. 1, Sec. 1, of the *Constitution of the United States* which vests all legislative authority in Congress. This authority may not be abdicated, nor transferred without the laying down of policy and establishment of standards for such transfer. This Court so held in *Panama Refining Co.* v. *Ryan,* 293 U. S. 388, 421, 429-430, 55 S. Ct. 241, 242, 252 (1934).

III.

An untrammeled power to establish groups makes a mockery of the only regulatory standard contained in the *Act.* The make-up of any group predetermines the evidentiary data from which an ostensibly just and reasonable rate conclusion is to be made. The group here selected

consists of high cost producers and low cost producers,[8] the aggregate of whose costs determined the rate result. It is a simple matter of logic that the exclusion from the group of the most substantial producers with high costs would have seriously reduced the aggregate cost, and elimination of the most substantial low cost producers would have substantially raised the aggregate cost. The peculiar characteristics of this industry explain without contradiction that the high or low costs of particular members of the group are not the result of extravagance, unreasonable expenditures, or particular efficiency, Appendix "B", P. 31a, *infra*. No justification for their aggregation and regulation as a group is even offered. That the geographical area selected is a well known producing area is no answer, when the record shows that producing operations and depth of production within the area are widely disparate. (From 7,000′ in Nolan County, Texas, to 25,000′ in Reeves and Pecos Counties, Texas, and back up to 6,000′ in Culbertson County, Texas, with more than 2,000 separate producing fields, JA 103-104; and see JA 141-142 as to range of drilling costs at different depths.

Assuming *arguendo* that the Act permits group rate fixing, it then must by implication require that groupings employed be reasonable, and, so construed, Petitioner has here been deprived of due process of law. By specific Commission order it was precluded from offering contentions to show that the selected area was not an appropriate pricing unit, *supra* at P. 4. It was denied hearing on a mat-

[8] Unit gas-well-gas cost, per Staff Exhibit 329, ranged from 2.9¢ to 170.5¢ per Mcf based on Appendix B data for Respondents with sales in excess of 10 Million Mcf (JA 35,837) and from 3.8¢ to 134.5¢ per Mcf for Appendix B data for Respondents with sales less than 10 Million Mcf (JA 35,838). The absolute correctness of these unit cost figures is unimportant. On any consistent method of cost determination the range of costs between Respondents in this group will be in similar proportions.

ter that materially affected the final conclusion. In *Natural, supra,* it was held that "the first prerequisite to an order by the Commission is that it shall be preceded by a hearing and findings", 315 U.S. at P. 583, 584. As held by this Court in *Morgan* v. *United States,* 304 U.S. 1, 14-15, 58 S. Ct. 773, 775 (1938): The expansion of administrative regulation is made possible under our system by adherence to the basic principles that the "Legislature shall appropriately determine the standards of administrative action" and the rights of the parties shall be protected by "the rudimentary requirements of fair play. These demand a fair and open hearing" which is an "inexorable safeguard". It was held in *Baltimore & Ohio RR Co.* v. *United States,* 298 U.S. 349, 363, 56 S. Ct. 797 (1936): "There is no statute that can be held to limit trial of an issue of confiscation."

If under any circumstances group rate fixing is authorized, as a prerequisite it must at least be shown that the group data is typical and representative of the operations of the members of the group since the make-up of the group in large measure determines the composite result.[9] A reasonable group, therefore, can include only companies with production from the same or similar depths with wells drilled at approximately the same time, or with drilling costs adjusted for changes over time.

A grouping based on gas production obtained from drilling to similar depths at approximately the same time would greatly narrow the range in costs between companies in

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[9] Should the Court see fit to grant this writ of certiorari Petitioner reserves the right to brief and argue the impropriety of the rates here derived on a group basis, their non-applicability to the operations of Petitioner, and the error of any requirement for refund by Petitioner, based on the rates established for the group, the costs of which are much below those of Petitioner.

the group. Then perhaps the express mandate of the *Act* that rates of each and every natural gas company shall be just and reasonable could be carried out. This would be accomplished by an *equitable division* of the group rate found just and reasonable among the high and low cost companies in the group.[10] Such division might permit the rates of any and all companies to be reasonable. This would avoid the windfall to some and bankruptcy to others, and give both consumers and producers the just and reasonable rate to which they have a right under Sec. 4(a) of the *Act*. Appendix "A", P. 2a hereof. This was hinted at, but not expressly required as it should have been, by the court below. Appendix "B", P. 53a hereof.

IV.

The holding of the court below that expense items, including dry hole expenses proper in an individual cost of service, are not the measure of a confiscatory rate is in conflict with prior decisions of this Court and of another Court of Appeals.

Natural, supra, held that the *Act's* "lowest reasonable rate" coincides with the Constitutional requirement of due process and just compensation preserved in the *Fifth Amendment. Hope, supra,* held that from a company point of view operation expenses and capital costs with return on investment commensurate with that in other enterprises with corresponding risks and sufficient to attract capital

[10] Such division is specifically provided for and required by the Interstate Commerce Act in respect to railroads, *The New England Division Case,* 261 U.S. 184, 43 S. Ct. 270 (1923). If group rate making under the *Natural Gas Act* is impliedly authorized because not specifically precluded, the implication for equitable division of rates is equally required from the Congressional provision that rates of any company must be just and reasonable and all other rates are unlawful.

must be obtained under a just and reasonable rate. The Fifth Circuit in *Forest Oil Company* v. *Federal Power Commission,* 263 F. 2d 622, 625, held that attraction of capital includes "the cost of finding potential fields as well as the drilling of dry wells that seem to be a necessary part of any continuing oil and gas business".

The *Act* does not contemplate that gas producers when subject to jurisdiction shall thereafter simply liquidate. The Commission here held that "continuing exploration and development of new reserves is necessary in the public interest". (JA 277,598).

Confiscation *vel non* is present in every rate determination under this *Act*. This Court should unequivocally reaffirm the rule announced in *Hope, supra,* and that of the Fifth Circuit, *supra.*

The case of *Columbus Gas and Fuel Co.* v. *Public Utilities Commission of Ohio,* 292 U. S. 398, 54 S. Ct. 763 (1934), relied on by the court below, does not support its decision on this point. The state statute there involved was struck down as being violative of the Fourteenth Amendment because it precluded allowance in operating expenses of "amortization of the value of leaseholds and wells and equipment thereon". The court further held:

> "When the allowance has been fixed and has been charged to operating expenses, it will supply the answer to other questions in controversy now * * * *." 292 U. S. at 406.

Here the question of *capitalizing,* rather than expensing, exploration costs was recognized by the Commission. Expensing was deemed proper to avoid departure from treatment in prior proceedings and industry accounting practices (JA 277,607-277,608). It was not doubted that such costs

must be recouped one way or the other under a just and reasonable rate.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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April, 1967

APPENDIX

APPENDIX "A"

THE CONSTITUTION OF THE UNITED STATES OF AMERICA

ARTICLE I

Section 1

Legislative powers vested in Congress. — All legislative Powers herein granted shall be vested in a Congress of the United States, which shall consist of a Senate and House of Representatives.

AMENDMENTS TO THE CONSTITUTION OF THE UNITED STATES

ARTICLE V

Trials for crimes; just compensation for private property taken for public use. — No person shall be * * * * * deprived of life, liberty, or property, without due process of law, nor shall private property be taken for public use, without just compensation.

THE NATURAL GAS ACT

SEC. 2. When used in this act, unless the context otherwise requires —

(1) "Person" includes an individual or a corporation.

(2) "Corporation" includes any corporation, joint-stock company, partnership, association, business trust, organized group of persons, whether incorporated or not, receiver or receivers, trustee or trustees of any of the foregoing, but shall not include municipalities as hereinafter defined.

— — — —

(6) "Natural-gas company" means a person engaged in the transportation of natural gas in interstate commerce, or the sale in interstate commerce of such gas for resale.

— — — —

RATES AND CHARGES; SCHEDULES; SUSPENSION OF NEW RATES

SEC. 4. (a) All rates and charges made, demanded, or received by any natural-gas company for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges, shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful.

(b) No natural-gas company shall, with respect to any transportation or sale of natural gas subject to the jurisdiction of the Commission, (1) make or grant any undue preference or advantage to any person or subject any person to any undue prejudice or disadvantage, or (2) maintain any unreasonable difference in rates, charges, service, facilities, or in any other respect, either as between localities or as between classes of service.

(c) Under such rules and regulations as the Commission may prescribe, every natural-gas company shall file with the Commission, within such time (not less than sixty days from the date this act takes effect) and in such form as the Commission may designate, and shall keep open in convenient form and place for public inspection, schedules showing all rates and charges for any transportation or sale subject to the jurisdiction of the Commission, and the classifications, practices, and regulations affecting such rates and charges, together with all contracts which in any manner affect or relate to such rates, charges, classifications, and services.

(d) Unless the Commission otherwise orders, no change shall be made by any natural-gas company in any such rate, charge, classification, or service, or in any rule, regula-

tions, or contract relating thereto, except after thirty days' notice to the Commission and to the public. Such notice shall be given by filing with the Commission and keeping open for public inspection new schedules stating plainly the change or changes to be made in the schedule or schedules then in force and the time when the change or changes will go into effect. The Commission, for good cause shown, may allow changes to take effect without requiring the thirty days' notice herein provided for by an order specifying the changes so to be made and the time when they shall take effect and the manner in which they shall be filed and published.

(e) Whenever any such new schedule is filed the Commission shall have authority, either upon complaint of any State, municipality, State commission, or gas distributing company[1a] or upon its own initiative without complaint, at once, and if it so orders, without answer or formal pleading by the natural-gas company, but upon reasonable notice, to enter upon a hearing concerning the lawfulness of such rate, charge, classification, or service; and, pending such hearing and the decision thereon, the Commission, upon filing with such schedules and delivering to the natural-gas company affected thereby a statement in writing of its reasons for such suspension, may suspend the operation of such schedule and defer the use of such rate, charge, classification, or service, but not for a longer period than five months beyond the time when it would otherwise go into effect;[1a] and after full hearings, either completed before or after the rate, charge, classification, or service goes into effect, the Commission may make such orders with reference thereto as would be proper in a proceeding initiated after it had become effective. If the proceeding has

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[1a] Subsection 4 (e) was amended May 21, 1962 by Public Law 87-454, 87th Congress, 2d Session [S. 1595], 76 Stat. 72.

not been concluded and an order made at the expiration of the suspension period, on motion of the natural-gas company making the filing, the proposed change of rate, charge, classification, or service shall go into effect. Where increased rates or charges are thus made effective, the Commission may, by order, require the natural-gas company to furnish a bond, to be approved by the Commission, to refund any amounts ordered by the Commission, to keep accurate accounts in detail of all amounts received by reason of such increase, specifying by whom and in whose behalf such amounts were paid, and, upon completion of the hearing and decision, to order such natural-gas company to refund, with interest, the portion of such increased rates or charges by its decision found not justified. At any hearing involving a rate or charge sought to be increased, the burden of proof to show that the increased rate or charge is just and reasonable shall be upon the natural-gas company, and the Commission shall give to the hearing and decision of such questions preference over other questions pending before it and decide the same as speedily as possible. [52 Stat. 822 (1938); 76 Stat. 72 (1962); 15 U.S.C. § 717c]

FIXING RATE AND CHARGES; DETERMINATION OF COST OF PRODUCTION OR TRANSPORTATION

SEC. 5. (a) Whenever the Commission, after a hearing had upon its own motion or upon complaint of any State, municipality, State commission, or gas distributing company, shall find that any rate, charge, or classification demanded, observed, charged, or collected by any natural-gas company in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Com-

mission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order: *Provided, however,* That the Commission shall have no power to order any increase in any rate contained in the currently effective schedule of such natural-gas company on file with the Commission, unless such increase is in accordance with a new schedule filed by such natural-gas company; but the Commission may order a decrease where existing rates are unjust, unduly discriminatory, preferential, otherwise unlawful, or are not the lowest reasonable rates.

(b) The Commission upon its own motion, or upon the request of any State commission, whenever it can do so without prejudice to the efficient and proper conduct of its affairs, may investigate and determine the cost of the production or transportation of natural gas by a natural-gas company in cases where the Commission has no authority to establish a rate governing the transportation or sale of such natural gas. [52 Stat. 823 (1938); 15 U.S.C. § 717d]

EXTENSION OF FACILITIES; ABANDONMENT OF SERVICE

SEC. 7. (a) Whenever the Commission, after notice and opportunity for hearing, finds such action necessary or desirable in the public interest, it may by order direct a natural-gas company to extend or improve its transportation facilities, to establish physical connection of its transportation facilities with the facilities of, and sell natural gas to, any person or municipality engaged or legally authorized to engage in the local distribution of natural or artificial gas to the public, and for such purpose to extend its transportation facilities to communities immediately

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adjacent to such facilities or to territory served by such natural-gas company, if the Commission finds that no undue burden will be placed upon such natural-gas company thereby: *Provided,* That the Commission shall have no authority to compel the enlargement of transportation facilities for such purposes, or to compel such natural-gas company to establish physical connection or sell natural gas when to do so would impair its ability to render adequate service to its customers. [52 Stat. 824 (1938); 15 U.S.C. § 717f (a)]

(b) No natural-gas company shall abandon all or any portion of its facilities subject to the jurisdiction of the Commission, or any service rendered by means of such facilities, without the permission and approval of the Commission first had and obtained, after due hearing, and a finding by the Commission that the available supply of natural gas is depleted to the extent that the continuance of service is unwarranted, or that the present or future public convenience or necessity permit such abandonment. [52 Stat. 824 (1938); 15 U. S. C. § 717f (b)]

(c)[2] No natural-gas company or person which will be a natural-gas company upon completion of any proposed construction or extension shall engage in the transportation or sale of natural gas, subject to the jurisdiction of the Commission, or undertake the construction or extension of any facilities therefor, or acquire or operate any such facilities or extensions thereof, unless there is in force with respect to such natural-gas company a certificate of public convenience and necessity issued by the Commission authorizing such acts or operations: *Provided, however,* That if any such natural-gas company or predecessor in interest was bonafide engaged in transportation or

[2] Subsection 7 (c) amended; (d), (e), (f) and (g) added February 7, 1942 by Public Law No. 444, 77th Congress, Chapter 49, 2d Session [H. R. 5249], 56 Stat. 83, 84.

sale of natural gas, subject to the jurisdiction of the Commission, on the effective date of this amendatory Act, over the route or routes or within the area for which application is made and has so operated since that time, the Commission shall issue such certificate without requiring further proof that public convenience and necessity will be served by such operation, and without further proceedings, if application for such certificate is made to the Commission within ninety days after the effective date of this amendatory Act. Pending the determination of any such application, the continuance of such operation shall be lawful.

In all other cases the Commission shall set the matter for hearing and — — — —

(d)[4] (omitted)

(e)[5] Except in the cases governed by the provisos contained in subsection (c) of this section, a certificate shall be issued to any qualified applicant therefor, authorizing the whole or any part of the operation, sale, service, construction, extension, or acquisition covered by the application, if it is found that the applicant is able and willing properly to do the acts and to perform the service proposed and to conform to the provisions of the Act and the requirements, rules, and regulations of the Commission thereunder, and that the proposed service, sale, operation, construction, extension, or acquisition, to the extent authorized by the certificate, is or will be required by the present or future public convenience and necessity; otherwise such application shall be denied. The Commission shall have the power to attach to the issuance of the certificate and to the exercise of the

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4, 5, 6 See footnote 2, p. 7.

rights granted thereunder such reasonable terms and conditions as the public convenience and necessity may require. [56 Stat. 84 (1942); 15 U. S. C. § 717f (e)]

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ADMINISTRATION POWERS OF COMMISSION; RULES, REGULATIONS, AND ORDERS

SEC. 16. The Commission shall have power to perform any and all acts, and to prescribe, issue, make, amend, and rescind such orders, rules, and regulations as it may find necessary or appropriate to carry out the provisions of this act. Among other things, such rules and regulations may define accounting, technical, and trade terms used in this act; and may prescribe the form or forms of all statements, declarations, applications, and reports to be filed with the Commission, the information which they shall contain, and the time within which they shall be filed. Unless a different date is specified therein, rules and regulations of the Commission shall be effective thirty days after publication in the manner which the Commissoin shall prescribe. Orders of the Commission shall be effective on the date and in the manner which the Commission shall prescribe. For the purposes of its rules and regulations, the Commission may classify persons and matters within its jurisdiction and prescribe different requirements for different classes of persons or matters. All rules and regulations of the Commission shall be filed with its secretary and shall be kept open in convenient form for public inspection and examination during reasonable business hours. [52 Stat. 830 (1938); 15 U.S.C. § 717o]

APPENDIX "B"

UNITED STATES COURT OF APPEALS
TENTH CIRCUIT

Nos. 8385, 8409, 8440, 8455, 8458, 8460, 8479, 8482, 8487, 8488, 8489, 8490, 8493, 8494, 8495, 8496, 8497, 8501, 8505, 8510, 8511, 8517, 8519, 8521, 8528, 8529, 8534, 8540, 8541, 8542, 8588 and 8589

JANUARY TERM, 1967

SKELLY OIL COMPANY; PHILLIPS PETROLEUM COMPANY; WARREN PETROLEUM CORPORATION; MOBIL OIL CORPORATION (formerly Socony Mobil Oil Company, Inc.); PAN AMERICAN PETROLEUM CORPORATION; NORTHERN NATURAL GAS PRODUCING COMPANY; STANDARD OIL COMPANY OF TEXAS, a Division of Chevron Oil Company; TEXACO INC.; HUNT OIL COMPANY jointly with H. L. Hunt, Lamar Hunt, N. B. Hunt, W. H. Hunt, Secure Trusts, Caroline and Loyd B. Sands, Caroline Hunt Trust Estate, Lyda Hunt-Caroline Trusts, Lyda Hunt-Bunker Trusts, Lyda Hunt-Lamar Trusts, Lyda Hunt-Herbert Trusts, Lyda Hunt-Margaret Trusts (formerly Estate of Lyda Bunker Hunt, Deceased), Hunt Industries (formerly Estate of Lyda Bunker Hunt, Deceased), and Placid Oil Company; HUMBLE OIL & REFINING COMPANY; SHELL OIL COMPANY; THE ATLANTIC RICHFIELD COMPANY (formerly The Atlantic Refining Company) jointly with Dorchester Gas Producing Company, Southland Royalty Company, and Westates Petroleum Company; CONTINENTAL OIL COMPANY jointly with Sunray DX Oil Company, Sinclair Oil & Gas Company, Cabot Corporation, Sohio Petroleum Company, Joseph E. Seagram & Sons, Inc., Joseph E. Seagram & Sons d/b/a Texas Pacific Oil Company, Gulf Oil Corporation, Murphy Oil Corporation, The Nueces Company, Samedan Oil Corporation, Cities Service Oil Company (formerly Cities Service Petroleum Corporation), Cities Service Production Company (now merged with Cities Service Oil Company), Columbian Fuel Corporation, Amerada Petroleum Corporation, Union Oil Company of California and as successor to The Pure Oil Company, Tidewater Oil Company, Reef Corporation, and

(Continued on next page)

William A. & Edward R. Hudson, Joint Operators; MARATHON OIL COMPANY; SUN OIL COMPANY; INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA; THE BRITISH-AMERICAN OIL PRODUCING COMPANY; UNION TEXAS PETROLEUM, a Division of Allied Chemical Corporation; MIDHURST OIL CORPORATION; THE SUPERIOR OIL COMPANY; PERRY R. BASS jointly with Panther City Investment Co., Bass Bros. Enterprises, Inc., Perry R. Bass, Incorporated, and Richardson Oils, Inc.; COLUMBIAN CARBON COMPANY jointly with Coltexo Corporation; THE STATE OF TEXAS; BIG CHIEF DRILLING COMPANY jointly with King-Stevenson Oil Company, Inc., and Service Drilling Company; TEXAS INDEPENDENT PRODUCERS AND ROYALTY OWNERS ASSOCIATION jointly with West Central Texas Oil and Gas Association; STATE OF NEW MEXICO; GULF OIL CORPORATION; and J. C. BARNES, et al.,

Petitioners,

v.

FEDERAL POWER COMMISSION,

Respondent,

STATE OF CALIFORNIA jointly with Public Utilities Commission of the State of California; CITY OF LOS ANGELES; CITY OF SAN DIEGO; CITY AND COUNTY OF SAN FRANCISCO; PACIFIC GAS AND ELECTRIC COMPANY; PACIFIC LIGHTING SERVICE AND SUPPLY COMPANY (formerly Pacific Lighting Gas Supply Company) jointly with Southern California Gas Company and Southern Counties Gas Company of California; and SAN DIEGO GAS AND ELECTRIC COMPANY,

Intervenors.

ON PETITION TO REVIEW ORDERS
OF THE FEDERAL POWER COMMISSION

Sherman S. Poland for Skelly Oil Company, petitioner in No. 8385. With him on the brief were Hawley C. Kerr, Richard J. Dent, Bradford Ross, and Ross, Marsh & Foster. Kenneth Heady, Carroll L. Gilliam, Jesse H. Foster, Jr., Oliver L. Stone, James J. Flood, Jr., Bruce R. Merrill, and Warren M. Sparks for the petitioners in Nos. 8409, 8440, 8455, 8458, 8460, 8482, 8488, 8489, 8490, 8493, 8494, 8497, 8505, 8517, 8534, 8540, 8541, 8542, 8588, and 8589. With them on the briefs were:

Thomas H. Burton, Jr., and Joseph C. Johnson for Continental Oil Company;

J. P. Greve for Sunray DX Oil Company;

A. A. Davidson, Charles Holmes, and Charles E. McGee for Sinclair Oil & Gas Company;

Homer D. Johnson and Boyd D. Taylor for Cabot Corporation;

Dixon Morgan, McAfee, Hanning, Newcomer, Hazlett & Wheeler, and Richard F. Remmers for Sohio Petroleum Company;

Eldon E. Scott, Donald J. Mulvihill, and Cahill, Gordon, Reindel & Ohl for Joseph E. Seagram & Sons, Inc., and Joseph E. Seagram & Sons d/b/a Texas Pacific Oil Company;

H. Y. Rowe for Murphy Corporation;

Chester L. Wheless for The Nueces Company;

George N. Otey, Jr., for Samedan Oil Corporation;

John C. Snodgrass and Vinson, Elkins, Weems & Searls for Union Oil Company and as successor to The Pure Oil Company;

Clyde E. Willbern for Tidewater Oil Company;
T. J. Caldwell, Jr., and Jerome M. Alper for Reef Corporation;

Edward R. Hudson for William A. & Edward R. Hudson, Joint Operators;

All as joint and several petitioners in No. 8493;

Cecil N. Cook and Neal Powers, Jr., for Midhurst Oil Corporation, petitioner in Nos. 8493 and 8505;
Wm. J. Zeman, Lloyd G. Minter, John R. Rebman, and Stanley L. Cunningham for Phillips Petroleum Company, petitioner in No. 8409;

Donald R. Arnett and Kenneth C. Keener for Gulf Oil Corporation, petitioner in Nos. 8493 and 8534, and Warren Petroleum Corporation, petitioner in Nos. 8493 and 8440;

Cecil C. Cammack, R. J. Leithead, and Graydon D. Luthey for Cities Service Oil Company (formerly Cities Service Petroleum Company), Cities Service Production Company (now merged with Cities Service Oil Company), and Columbian Fuel Corporation, petitioners in No. 8493, and Coltexo Corporation and Columbian Carbon Company, petitioners in No. 8517;

Joseph W. Morris and Edwin S. Nail for Amerada Petroleum Corporation, petitioner in Nos. 8493 and 8542;

Tom P. Hamill, Robert D. Haworth, Donald G. Canuteson, and D. Lamar Smith for Mobil Oil Corporation (formerly Socony Mobil Oil Company, Inc.), petitioner

in Nos. 8455 and 8588, and Northern Natural Gas Producing Company, petitioner in No. 8460;

J. P. Hammond, T. C. McCorkle, William H. Emerson, and Clifford O. Stone, Jr., for Pan American Petroleum Corporation, petitioner in No. 8458;

William K. Tell, Jr., for Texaco Inc., petitioner in Nos. 8482 and 8541;

Carl Illig and William H. Holloway for Humble Oil & Refining Company, petitioner in No. 8488;

Thomas G. Johnson for Shell Oil Company, petitioner in No. 8489;

Stuart J. Scott, Bernard A. Foster, Jr., and Ross, Marsh & Foster for The Atlantic Richfield Company (formerly The Atlantic Refining Company), Southland Royalty Company, Westates Petroleum Company and Dorchester Gas Producing Company, petitioners in No. 8490, and The British-American Oil Producing Company, petitioner in No. 8497;

Clayton L. Orn, Joseph F. Diver, Morton Taylor, and Jack Fariss for Marathon Oil Company, petitioner in Nos. 8494 and 8540;

F. H. Pannill, Hamilton E. McRae, and Stubbeman, McRae, Sealy & Laughlin for J. C. Barnes, et al., petitioners in No. 8589.

Claude Proctor, Justin R. Wolf, Eugene E. Threadgill, and Wolf & Case were on the brief for Standard Oil Company of Texas, a Division of Chevron Oil Company, petitioner in No. 8479.

Robert W. Henderson for Hunt Oil Company, et al., petitioners in No. 8487. With him on the brief was Paul W. Hicks.

Louis Flax for Sun Oil Company, petitioner in No. 8495. With him on the brief were Phillip D. Endom, Robert E. May, and May, Shannon and Morley.

William I. Powell for Independent Petroleum Association of America, petitioner in No. 8496. With him on the brief was L. Dan Jones.

H. W. Varner for Superior Oil Company, petitioner in No. 8510. With him on the brief was Murray Christian.

J. Evans Attwell for Perry R. Bass, et al., petitioners in No. 8511. With him on the brief were W. H. Drushel, Jr., and Vinson, Elkins, Weems & Searls.

Waggoner Carr, Attorney General, for the State of Texas, petitioner in No. 8519. With him on the brief were Hawthorne Phillips, First Assistant Attorney General, T. B. Wright, Executive Assistant, J. Arthur Sandlin, C. Daniel Jones, Jr., and Linward Shivers, Assistant Attorneys General, of the State of Texas.

Lewis G. Mosburg, Jr., for Big Chief Drilling Company, et al., petitioners in No. 8521. With him on the brief were A. P. Murrah, Jr., Leland C. Neeley, Jr., Mosteller, Andrews & Mosburg, Jerry F. Lyons, and Underwood, Wilson, Sutton, Heare & Berry.

John Davenport for Texas Independent Producers & Royalty Owners Association and West Central Texas Oil and Gas Association, petitioners in No. 8528.

Boston E. Witt, Attorney General, and William J. Cooley, Special Assistant Attorney General, for the State of New Mexico, petitioner in No. 8529.

Richard A. Solomon, General Counsel, and Peter H. Schiff, Deputy Solicitor, Federal Power Commission, for the respondent. With them on the brief were Howard E. Wah-

renbrock, Solicitor, Leo E. Forquer, David J. Bardin, Assistant General Counsels, Alan J. Roth, and James D. Annett, Attorneys, Federal Power Commission.

J. Calvin Simpson, Senior Counsel, for People of the State of California, Public Utilities Commission of the State of California, City of Los Angeles, City of San Diego, and City and County of San Francisco, intervenors. With him on the brief were:

Mary Moran Pajalich, Chief Counsel, and William N. Foley, Associate Counsel, for the People of the State of California and Public Utilities Commission of the State of California;

Roger Arnebergh, City Attorney, for the City of Los Angeles;

Edward T. Butler, City Attorney, and Edwin L. Miller, Jr., Assistant City Attorney, for the City of San Diego;

Thomas M. O'Connor, City Attorney, William F. Bourne, Public Utilities Counsel and Deputy City Attorney, and McMorris M. Dow, Deputy City Attorney, for the City and County of San Francisco.

William L. Cole, Malcolm H. Furbush, and C. Hayden Ames for Pacific Gas and Electric Company, Pacific Lighting Service and Supply Company (formerly Pacific Lighting Gas Supply Company), San Diego Gas & Electric Company, Southern California Gas Company and Southern Counties Gas Company of California, intervenors. With them on the brief were:

John Ormasa and Roger J. Nichols for Pacific Lighting Service and Supply Company, Southern California Gas Company, and Southern Counties Gas Company of California;

Frederick T. Searls and Stanley T. Skinner for Pacific Gas and Electric Company;

Sherman Chickering and Donald J. Richardson, Jr., for San Diego Gas & Electric Company.

A brief Amicus Curiae supporting respondent was filed by J. David Mann, Jr., John E. Holtzinger, Jr., Frederick Moring, and Morgan, Lewis & Bockius on behalf of the Associated Gas Distributors Group.

Oklahoma Independent Petroleum Association, A & R Pipe Co., et al., Panhandle Producers & Royalty Owners Association, and Malouf Abraham Company, et al., joined in the brief of Big Chief Drilling Company, et al., as Amicus Curiae supporting petitioners.

Before LEWIS, BREITENSTEIN and HILL,
Circuit Judges.

BREITENSTEIN, Circuit Judge.

The first area rate decision of the Federal Power Commission is before us for review. It relates to prices for jurisdictional sales of natural gas produced in the Permian Basin, a famous petroleum area where oil and gas are found in hundreds of reservoirs and thousands of wells. The states of Texas and New Mexico, the nation's oil and gas industry, and several related associations attack the decision. The State of California, the cities of San Francisco, Los Angeles, and San Diego, various local distributors, and an organization of such distributors support it. The rejection of the individual company cost-of-service approach to the regulation of independent producers and the adoption of the area rate method raise many novel issues which have been extensively and ably argued. We hold that neither the United States Constitution nor the Natural Gas Act bars the regulation of natural-gas prices on an area basis; that the Commission did not abuse its discretion in adopting the area method; and that the cases must be remanded because the actions of the Commission do not comply with the end result test established in Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 602-603, and other decisions.

The petitions for review, all brought under § 19(b) of the Natural Gas Act,[1] attack Opinions Nos. 468 and 468-A of the Commission fixing just and reasonable rates under

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[1] 15 U.S.C. §§ 717-717w.

§§ 4 and 5 of the Act for natural gas produced in the Permian Basin and sold to interstate pipeline companies.

1. **Background.**

The Permian Basin, as defined by the Commission, includes Texas Railroad Commission Districts Nos. 7-C, 8, and 8-A and the New Mexico counties of Chaves, Eddy, and Lea. Nationally, it accounts for about 11% of all the gas sold in interstate commerce. The Commission joined 336 producers as respondents in the consolidated proceedings. Sales by them are made to three interstate pipelines, none of which appear here.[2] About 85% of the Permian gas moving interstate goes to California.

Nearly two-thirds of the Permian gas production comes from oil-well gas, that is, gas produced in conjunction with oil. Because of impurities much of the gas must be processed before introduction to an interstate pipeline. Until El Paso began its purchases, Permian oil-well gas was generally vented or flared because of the lack of a market.

The natural-gas industry has three main parts, the producers, the interstate pipelines, and the distributors. The last are under state or local regulation exclusively. The Commission began federal regulation of the interstate pipelines after the passage of the Natural Gas Act of 1938. It did not attempt to regulate independent producers[3] until the 1954 decision of the Supreme Court in Phillips Petro-

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[2] El Paso Natural Gas Company began buying Permian gas in 1945, Northern Natural Gas Company through a predecessor in 1954, and Transwestern Pipeline Company in 1958. In 1961, El Paso purchased 73% of the Permian gas moving in interstate commerce, Northern 18%, and Transwestern 9%.

[3] The word "independent" is used to describe a producer which does not transmit gas interstate either by its own operations or those of an affiliate. Some of the interstate pipelines produce a share of their own gas and sell gas to other pipelines.

leum Co. v. Wisconsin, 347 U.S. 672, (First Phillips) which held that the Act applied to them.

Section 7 of the Act forbids the sale of natural gas subject to Commission jurisdiction without a certificate of public convenience and necessity granted after notice and hearing. Temporary certificates, issued without notice and hearing, are authorized. Our recent decision in Sunray DX Oil Company v. Federal Power Commission, 10 Cir., ..., F. 2d ....., discusses § 7 procedures and problems. These are not present here because the § 7 applications considered in the consolidated proceedings before the Commission were disposed of in a separate order.

Section 4 requires that all rates shall be just, reasonable, and nondiscriminatory. No change shall be made in a rate without 30 days' notice. When a schedule containing a changed rate is filed, the Commission on its own initiative or on complaint may suspend the rate and set the matter for hearing. The suspension may be for not longer than five months. If no decision is reached within that period, the increased rate becomes effective but the Commission may require a bond conditioned upon the refund of that portion of the increased rate found not to be justified. The instant proceedings involve a number of increased rate filings which were suspended under § 4 and which were disposed of by Opinions Nos. 468 and 468-A.

Section 5 provides that whenever the Commission, after hearing had on its own motion or on complaint, finds that a rate is "unjust, unreasonable, unduly discriminatory, or preferential" it shall determine "the just and reasonable rate." In the proceedings at bar the Commission pursuant to § 5 established "the future rates for jurisdictional sales of gas by producers in the area."

After the First Phillips decision the Commission received thousands of certificate applications from producers. The situation was complicated by the need of pipelines for a committed source of supply sufficient to justify financing. To obtain such supply long-term contracts, commonly for 20 years, were made with the producers. They in turn, because they could not file unilaterally for an increased rate contrary to contract and because they desired protection against the unforeseeable economic conditions of the future, insisted on escalation clauses of various types.[4] A general price rise occurred. As the escalation provisions became operative the producers filed under § 4 for increased rates and the Commission suspended many of them. Section 7 applications were under contracts calling for rates comparable to those which the Commission had suspended. This trend was ended by the 1959 decision in Atlantic Refining Co. v. Public Service Commission of New York, 360 U.S. 378, (CATCO) which directed the Commission in certificate cases to keep initial prices in line.

After the remand in First Phillips, the Commission proceeded with the consideration of just and reasonable rates required by §§ 4 and 5 on the individual company cost-of-service basis which it had long applied in the regulation of electric power companies and interstate pipelines. The first case to reach the decisional stage was that relating to Phillips. On September 28, 1960, the Commission entered Opinion No. 338[5] in which it held that the regulation of independent producers under the Act could be accomplished more appropriately by the establishment of area rates than by the establishment of producer rates on individual cost-of-service findings. Contemporaneously with this Phillips

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[4] See Pan American Petroleum Corporation v. Federal Power Commission, 10 Cir., 352 F. 2d 241, 243.

[5] 24 FPC 537.

decision, the Commission promulgated its Statement of General Policy No. 61-1[6] which established 23 rate areas and, with unimportant exceptions, announced maximum rates for each area. Two price standards were set, one for initial prices in new contracts and one for escalated prices in existing contracts. For the Permian Basin area the prices were 16 cents and 11 cents respectively.

Opinion No. 338 was affirmed by the Court of Appeals for the District of Columbia Circuit[7] and by the Supreme Court in Wisconsin v. Federal Power Commission, 373 U.S. 294, 310, (Second Phillips) wherein the Court observed that it shared "the Commission's hopes that the area approach may prove to be the ultimate solution" to the problem of regulating the independent producers.

The first area rate proceeding was that for the Permian Basin and was initiated on December 23, 1960.[8] It was followed by a similar proceeding for the South Louisiana area,[9] for the Hugoton-Anadarko area,[10] and for the Texas Gulf Coast area.[11] The last three are in the hearing stage. The Permian Basin proceeding was decided by Opinions Nos. 468 and 468-A to which we turn.

2. The Decision of the Commission.

The 131-page original opinion, No. 468, followed by the 23-page opinion denying rehearing, No. 468-A, need only be summarized at this point. The Commission found the area rate principle free from constitutional and statutory

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[6] 24 FPC 818.

[7] Wisconsin v. Federal Power Commission, D.C. Cir., 303 F. 2d 380.

[8] Docket No. AR61-1, 24 FPC 1121.

[9] Docket No. AR61-2, 25 FPC 942.

[10] Docket No. AR64-1, 30 FPC 1354.

[11] Docket No. AR64-2, 30 FPC 1354.

objections and adopted it. Contract prices were rejected as a basis for regulation and the reserves to production ratio was declared to be an inappropriate regulatory standard. The Commission set up a two-price system. It differentiated between gas produced as the sole product of a well, referred to as gas-well gas, and gas produced in association with oil, known as oil-well gas or casinghead gas. One price was established for new gas-well gas and the residue therefrom sold under contracts made on or after January 1, 1961. A second price was established for flowing gas which was defined to include gas-well gas sold under contracts executed before the mentioned date, casinghead gas, and residue gas derived from either source. The January 1, 1961, date of division between new gas-well gas and oil gas-well gas was adopted because that was the approximate date when the industry became able to direct its exploration efforts toward finding gas-well gas as distinguished from finding gas as a by-product in the search for oil. For new gas-well gas the Commission fixed a rate of 16.5 cents per Mcf for the Texas Railroad Districts inclusive of state and local taxes and a rate of 15.5 cents per Mcf for the New Mexico counties exclusive of applicable state and local production taxes. For flowing gas the respective rates were 14.5 cents and 13.5 cents.

In determining these rates the Commission gave consideration to composite costs but treated the two categories of new gas-well gas and flowing gas differently. It said that the price of the former "was geared to the cost of finding and producing future gas supplies and as such was built up primarily from nationally published statistics and the questionnaire data." For flowing gas it said "our touchstone is the historical cost of gas being produced in the Permian Basin area."

The Commission required adjustment on an individual company basis from the stated prices to reflect differentials from the quality standards. These downward adjustments are determined "by the net cost of processing the gas to bring it up to standard." A downward adjustment is also required if the Btu content is less than 1,000 per Mcf and an upward adjustment is permitted if that content is above 1,050.

Small producers, defined as those making less than 10 million Mcf of jurisdictional sales annually, are exempt from the quality adjustments and from certain filing requirements.

The Commission set a minimum price of 9.0 cents per Mcf. Provision is made for special exemption from area rates. Refunds of excess collections are required on an individual company basis. The possibility of changes in area rates is recognized. A moratorium, until January 1, 1968, is declared on rate increases and indefinite escalation clauses are prohibited.

Three commissioners filed separate opinions. With one exception Commissioner O'Connor approved the results reached but said that "the contract price at which most producers are able and willing to operate is just and reasonable" and that "composite costs best serve as a check on average field prices to preclude significant price departures." He disapproved the Btu adjustment saying that an upward adjustment should be applied for all gas having a Btu content in excess of 1,000. Comissioner Ross was critical of accounting methods used and pointed out the need for simplification. He dissented from the division date between new and old gas-well gas. In his view the new gas-well gas price should apply to gas sold after the date of the Commission decision. Commissioner Black said that the allowed 12% rate of return on net investment "is

very probably a generous one" but was justified by the special risk of finding substandard gas in the Permian Basin.

3. Disqualification of Two Commissioners.

The Continental Group of petitioners urges that Commissioner Black was disqualified to participate in the decision. The Independent Petroleum Association of America, (IPAA) complains of the participation of both Commissioners Swidler and Black. The claim is that each of them had prejudged the issue of whether substantial competition existed among producers. Additionally, Commissioner Black is accused of personal bias against the producers. The charges stem from public addresses made in 1964.[12] No claim is made that either commissioner prejudged the ultimate issue of a just and reasonable rate. In our opinion no basis for disqualification arises from the fact or assumption that a member of an administrative agency enters a proceeding with advance views on important economic matters in issue. Nothing in the record disturbs the assumption that the two commissioners are "men of conscience and intellectual discipline, capable of judging a particular controversy fairly on the basis of its own circumstances."[13] The cases cited by Continental and IPAA are not in point.[14]

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[12] A motion for the disqualification of Commissioner Black was made to and denied by the Commission. We find no similar motion in the record pertaining to Commissioner Swidler.

[13] United States v. Morgan, 313 U.S. 409, 421. See also Federal Trade Commission v. Cement Institute, 333 U.S. 683, 700-703.

[14] In Texaco, Inc., v. Federal Trade Commission, D.C. Cir., 336 F. 2d 754, vacated 381 U.S. 739, the charge was precommitment of a commissioner on the guilt of an accused. In Gilligan, Will & Co. v. Securities and Exchange Commission, 2 Cir., 267 F. 2d 461, certiorari denied 361 U.S. 896, a similar charge was made

4. Objections of Texas and New Mexico.

The states of Texas and New Mexico, besides adopting the briefs and arguments of the Continental Group, assail the Commission decision on grounds peculiar to them in their governmental capacity. They say that the public interest, which the Commission is required to protect, includes the producing states as well as the consuming states; that the prices which the Commission has set will cause a cessation or curtailment of exploration and development activities to the serious injury of the economy of the Permian Basin; that waste rather than conservation of a natural resource will result; and that the states and their public entities will suffer severe losses in taxes and royalty payments.[15] Similar arguments were made by West Virginia in Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 607-614, and were rejected by the Supreme Court which said that when Congress passed the Natural Gas Act it "was quite aware of the interests of the producing states in their natural gas supplies" and that nothing in the Act intimates that high prices should be maintained so that "the producing states obtain indirect benefits." The rejection of the state's contentions in Hope requires the rejection of the same contentions here.

Texas and New Mexico also argue that the Commission has unlawfully interfered with their power of taxation.

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against a commission. Amos Treat & Co. v. Securities and Exchange Commission, D.C. Cir., 306 F. 2d 260, related to a charge against a commissioner who had previously served as a staff member in the investigation which led to the complaint.

[15] In Texas 4.7 million acres of public lands are within the Permian Basin and in New Mexico over 3 million acres. Much of this land is leased for oil and gas and produces royalty income.

The Commission fixed the rates of gas produced in Texas to include all state taxes and in New Mexico to exclude such taxes. It said that: "In the event of any increase in taxes in Texas or New Mexico, the Commission will consider whether ceiling prices shall be increased and, if so, to what extent." The states' arguments are premature. The Commission has allowed all present taxes as a cost item. Nothing in the Commission decision inhibits the states from increasing those taxes. The Commission has said that if they do, it will determine whether such increases should be passed on to the consumer or remain on the shoulders of the producers. The question of whether increased state taxes will unreasonably burden interstate commerce is hypothetical at this stage.

New Mexico complains that the establishment of a ceiling price plus existing taxes for gas produced in its portion of the Permian Basin denies to it the power to provide a tax incentive to producers by reducing the tax. The argument is not persuasive. If the New Mexico tax was reduced, the Commission could properly consider a rate decrease to reflect the tax decrease.

5. Legality of Area Rates for Permian Basin.

The problems confronting federal regulation of the natural-gas business, and particularly the independent producers, have been discussed several times[16] and need be only summarized. The interstate gas business is concerned with a wasting, nonreplenishable natural resource subject to production after discovery. At the point where the gas enters interstate commerce there are few buyers and thou-

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[16] See opinions of Justice Jackson dissenting in Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 628, and concurring in Colorado Interstate Gas Co. v. Federal Power

sands of sellers. The producers range from the financially powerful integrated oil companies to the wildcatters who operate on a shoestring. Their results are measured by the amount of gas produced — not by the amount of money invested. Exploration and development costs are financed out of current income and are charged to expense rather than capital. The uncertainty of the business causes substantial cost and revenue fluctuations not only from producer to producer but also from year to year for the same producer. A regulated commodity, gas, is produced in substantial quantities along with an unregulated commodity, oil. The allocation of costs between them baffles the experts and presents the temptation to use mathematical means of arriving at a predetermined result. The same rate may bring a financial windfall to one producer and a financial disaster to another. The price of gas must be competitive with that of other sources of energy and must be sufficienlty attractive to encourage a continued search for new supplies.

In Federal Power Commission v. Natural Gas Pipeline Co., 315 U.S. 575, 582, a case relating to pipeline rates, the Court held that the provisions of the Act were consistent with the due process clause of the Fifth Amendment and within the commerce power. Another pipeline case, Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 602, says that in fixing rates the Commission is "not bound by the use of any single formula or

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Commission, 324 U.S. 581, 608; dissenting opinion of Justice Douglas in First Phillips, 347 U.S. 672, 687; dissenting opinions of Justice Clark in First Phillips, 347 U.S. 672, 690, and in Second Phillips, 373 U.S. 294, 315; dissenting opinion of Justice Harlan in Sunray Mid-Continent Oil Co. v. Federal Power Commission, 364 U.S. 137, 159; and Opinion No. 338 of the Commission, 24 FPC 537, 542-548.

combination of formulae"; that "under the statutory standard of 'just and reasonable' it is the result reached not the method employed which is controlling"; and that the impact of the rate order rather than the theory behind it is the governing criterion. The "end result" test of Hope was followed in Colorado Interstate Gas Co. v. Federal Power Commission, 324 U.S. 581, 605-606.

Second Phillips, 373 U.S. 294, holds that the Commission did not abuse its discretion in terminating the § 5 investigation of Phillips' rates and substituting an area basis for an individual company basis. The Court reaffirmed the principles announced in Natural, Hope, and Colorado Interstate, recognized the difficulties inherent in the regulation of the price of natural gas, shared the Commission's hope for the success of the area approach, and observed that the "case might be different if the area approach had little or no chance of being sustained."[17] At the same time, the Court pointed out that "the lawfulness of the area pricing method" was not before it for review.[18] Four justices dissented in an opinion which characterized the area rate policy of the Commission as "a new, untried, untested, inchoate program which, in addition, is of doubtful legality."[19]

In Callery[20] the Court mentioned that the § 7 proceedings before it had at one time been consolidated with the South Louisiana area rate proceedings. Contrary to the argument of the California Distributors the Court did not, tacitly or otherwise, approve area rate regulation. The

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[17] 373 U.S. 294, 310, 314.

[18] Id. at 308.

[19] Id. at 317.

[20] United Gas Improvement Co. v. Callery Properties, Inc., 382 U.S. 223, 225-226.

most pertinent comment is that of Justice Harlan in his concurring and dissenting opinion who said that area pricing "ultimately aims to simplify proceedings under the statute."[20a]

We cannot accept the arguments of the Commission and the California groups that the Supreme Court has determined the validity of area pricing under the Act. We read the decisions to mean that the Court has permitted the Commision to go forward with the area rate experiment and wishes it good luck in the development of a workable procedure which will be free from constitutional and statutory pitfalls.

Governmental price regulation of services and commodities on a group or geographical basis has been upheld in a number of decisions[21] under the federal commerce and war powers and under state police powers. Those supporting the Commission place great reliance on these decisions. The producers painstakingly distinguish each from the case at bar. We decline to be drawn into these tortuous sidepaths because we are convinced that the "translation of an impli-

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[20a] Id. at 231.

[21] See The New England Divisions Case, 261 U.S. 184 (ICC — divisions of joint rates); Aetna Insurance Co. v. Hyde, 275 U.S. 440 (Missouri regulation of fire insurance rates); Tagg Bros. v. United States, 280 U.S. 420 (Packers and Stockyards Act of 1921); Nebbia v. New York, 291 U.S. 502 (New York Milk Control Act); United States v. Rock Royal Co-op., 307 U.S. 533 (Agricultural Marketing Agreement Act of 1937); Sunshine Anthracite Coal Co. v. Adkins, 310 U.S. 381 (Bituminus Coal Conservation Act); Bowles v. Willingham, 321 U.S. 503 (Emergency Price Control Act of 1942); New York v. United States, 331 U.S. 284 (ICC — railroad rates); and Ayrshire Collieries Corp. v. United States, 335 U.S. 573 (ICC — railroad rates).

cation drawn from the special aspects of one statute to a totally different statute is treacherous business,"[22] Specific reference need be made to only one decision. Several producers emphasize the statement in Bowles v. Willingham, 321 U.S. 503, 517, that in the Natural Gas Act "Congress has provided for the fixing of rates which are just and reasonable in their application to particular persons or companies." The argument is that by this language the Supreme Court has recognized that regulation under the Act is on an individual company rather than group basis. We do not agree. The statement is dicta and whatever value it might have had as dicta was, in our opinion, destroyed by the blessing which the Court gave area rate making in Second Phillips.

Producers urge that the language of the Act is contrary to regulation on a group basis because all pertinent references to natural-gas companies are in the singular. First Phillips holds that an independent producer is a "natural-gas company" within the purview of the Act. Section 2, the definitions section, provides that "person" means an individual or corporation, and defines "natural-gas company" to mean a person engaged in transportation or sale of natural gas in interstate commerce. Section 4, covering the filing and changing of rates, refers to "any natural-gas company," "no natural-gas company," "every natural-gas company," and "the natural-gas company." Section 5, authorizing investigation and determination of rates, refers to "any rate," by "any natural-gas company" and to "such natural-gas company." Section 7 provides for certificates of public convenience and necessity and uses the terms "a natural-gas company," "no natural-gas company" and "such natural-gas company." The repeated use of the singular

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[22] Federal Trade Commission v. Bunte Bros., 312 U.S. 349, 353.

rather than the plural is said to require that the just and reasonable rate of each particular seller be tested with reference to its peculiar circumstances and operations.

Opposing arguments point out that the Act does not prohibit group or area rate making and that § 16 empowers the Commission to perform any and all acts and to prescribe such orders, rules, and regulations "as it may find necessary or appropriate to carry out the provisions of this act."

The basic query is whether the just and reasonable standard applies on an individual company basis or on a group basis. Section 4(a) says that "all rates * * * made * * * by any natural-gas company * * * shall be just and reasonable * * *." If this means that each producer is entitled to a rate which will return its costs plus a reasonable profit, the inquiry is at an end because the Commission refused to receive individual cost figures.

The Natural, Hope, Colorado Interstate, and Second Phillips decisions all support the conclusion that in the regulation of natural-gas rates the Commission is not bound by any formula or method, and that the choice of the appropriate method for the determination of those rates lies in the sound discretion of the Commission. The appropriateness of the method depends on the peculiar characteristics of the natural-gas industry.

In its Opinion No. 338,[23] the Commission noted the reasons why the individual company cost-of-service method was inapplicable and unworkable. Among these were the lack of a fixed determinable relationship between investment and service to the public with the result that "a huge investment might yield only a trickle of gas, while a small investment might lead to a bonanza," the staggering allocation problems which could result in such anomalies as

[23] 24 FPC 537.

widely varying prices for gas coming from a jointly owned lease or even from a jointly owned well, and the intolerable administrative burden of requiring a separate rate determination for each of the several thousand independent producers.

The powerful contrary argument is that no area rate, whether based on composite costs, average aggregate costs or any other industry wide criteria, will suffice to assure a high cost producer of its costs to say nothing of a profit. We accept this as true.[24] The impact of an area rate in the natural-gas industry may have effects which cover the entire range from bonanza to bankruptcy. It is sufficient for us that these results were lucidly demonstrated in the dissenting opinion of Justice Clark in Second Phillips and did not deter the majority from allowing the Commission to proceed with its area rate program.

Some of the producers argue that if the Act is construed to permit area rate making, the Act is invalid under Art. I, § 1, of the United States Constitution because no legislative standards have been set for establishing groups or making group determinations. Reliance is had on Panama Refining Co. v. Ryan, 293 U.S. 388, which held that a delegation of legislative power to the President was unconstitutional because Congress, among other things, "has declared no policy, has established no standard, has laid down no rule."[25]

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[24] An appendix to the Hunt brief presents an array of natural-gas costs of 44 Permian producers whose volumes total over 208 million Mcf. Of these, 16 producing over 170 million Mcf are shown to have costs of less than 14.5 cents. The remainder have costs running from 14.77 cents to 216.05 cents. We have been unable to check the accuracy of these figures and mention them only to show the claimed disparity of costs. Continental says that "approximately 67 percent of the companies and approximately 30 percent of the volumes had costs above the industry average cost level."

[25] 293 U.S. 388, 430.

Congress cannot delegate its power to enact laws but it can confer on an administrative agency the power to carry into effect laws which it has enacted.[26] In the New England Divisions Case, *supra,* the Court referred to the power given by Congress to the Interstate Commerce Commission to determine just and reasonable rates and said that Congress "intended that a method should be pursued by which the task * * * could be performed."[27] In Lichter v. United States, 334 U.S. 742, 785-786, the Court in discussing legislative standards said that the "standards prescribed by Congress are to be read in the light of the conditions to which they are applied" and for an example observed that "among those which have been held to state a sufficiently definite standard for administrative action [are] 'just and reasonable' rates for sales of natural gas."

In the regulation of the natural-gas industry "the actual necessities of procedure and administration"[28] have led to the adoption of the area rate method. We believe that neither constitutional nor statutory provisions prevent the use of that method and that the Commission did not abuse its discretion in adopting it. The more important and difficult question is that of the validity of the area rates which have been established. The controlling standard is the end result test of Hope. In our opinion, this test is accepted by, and reaffirmed in, the Second Phillips decision.

Some of the producers urge that the area rate method is not consistent with the characteristics of the industry and that contract prices satisfy statutory requirements because they have been reached through effective competition. The Commission considered and rejected the argument. It point-

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[26] Crain v. First National Bank of Oregon, Portland, 9 Cir., 324 F. 2d 532, 537.
[27] 261 U.S. 184, 197.
[28] Id. at 198.

ed to the history of price negotiations in the Permian Basin, to the urgent requirements of the pipelines, to the heavy percentage of sales by a few producers, and to the control of undisclosed and uncommitted gas reserves by a few producers. It concluded that the record fails to establish that a just and reasonable rate can be established through competition and that "the primary competition revealed by the record was among the pipelines to secure new gas supplies at higher prices." Commissioner O'Connor disagreed saying that "the contract price at which most producers are able and willing to operate is just and reasonable." His conclusion was that "profit oriented costs and supply oriented contracts do not, in the aggregate, depart in any significant manner from each other." We accept the conclusion of the Commission that competition has not been effective to fix a just and reasonable rate. It is supported by reasonable inferences from the record and they are binding on us.

Continental and Superior say that they were improperly denied an opportunity to be heard on the geographical propriety of the Permian Basin as a rate area. In its order instituting the proceedings the Commission eliminated the issue of the appropriateness of the area for rate making purposes.[29] The Commission may draw on its expertise to determine the ground rules for an investigation but in so doing may not deny a specific right.[30] The producers fail to convince us that any such denial has occurred here. The Permian Basin is a well known area. Unless prices are to be determined on a national basis, areas must be selected and defined. The Commission had two choices. It could first determine the national revenue requirement and di-

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[29] 24 FPC 1121, 1122.

[30] Amax Petroleum Corporation v. Federal Power Commission, 10 Cir., 350 F. 2d 92, 94.

vide that up among the areas or it could first determine the various rates so that in the aggregate they meet that requirement. We are unwilling to assume that when all the area proceedings are completed the total revenue will not equal the national requirement. If it does not, both the producers and the consumers will suffer. In our opinion the Commission acted reasonably in selecting the Permian Basin for an area rate proceeding.

6. **The Two-Price System.**

The Commission's two-price system is vigorously attacked on many fronts. It will be remembered that one price is fixed for new gas-well gas and another for flowing gas. All agree that gas is a commodity which is valuable as a source of energy. The householder does not care whether the gas which burns at the tip of his appliance comes from a gas well, an oil well, or as a residue product. To him gas is gas.

The justification for the two-price system is that the higher price for new gas-well gas provides an incentive to explore for and develop new supplies. The producers do not question the finding that "the industry is increasingly becoming able to direct its exploration efforts toward finding new gas-well gas as distinguished from finding gas as a by-product in the search for oil." This ability may be confined to the larger companies which maintain the technical staffs skilled in making the necessary predictions. The smaller producers are in a less advantageous position. They may be relegated to the farmouts which the majors pass down to them or to operations in accord with their less scientific but sometimes financially rewarding hunches.

New gas discoveries are well said to be the life blood of the industry. The consumers may reasonably be required to pay the price needed to bring forth such discoveries. If

an incentive price based on current costs is used for all gas, windfalls will be assured to many producers of old gas developed under lower historical costs and often found in association with oil.

The producers say that a single-price system based on current costs is required because revenues for current exploration and development must be internally generated from sales of gas from whatever source. The Commission rejected the argument. The question is not so much the source of the funds as it is the inducement to use available funds in the search for gas. The higher price for new gas is intended to supply that inducement. Although the adequacy of the inducement can only be tested by future developments, we are not convinced that the refusal of the Commission to include the same inducement in the price of old gas, with the resulting likelihood of wind-falls, was unreasonable.

Continental, Phillips, and others argue that the two-price system amounts to entrapment because of the possibility of reduction in price after financial commitments have been made. Although the Commission which announced the Permian Basin decision cannot bind a future Commission, we credit the Commission with good faith. The possibility of a change does not invalidate the rate method employed. When and if a reduction occurs, the argument of entrapment can be heard.

The division date of January 1, 1961, for the different prices of new gas-well gas and old gas-well gas is another subject of dispute. Here the Commission found as a fact that the appropriate date was the approximate time when directional drilling came to be used effectively. Under the evidence the selection of a division date was an administrative problem calling for the exercise of judgment. In making its choice the Commission acted within the evidence and

within its powers. On rehearing, the Commission left open for future consideration the problem arising when new gas-well gas is developed from committed acreage. We assume that this problem will be met fairly when it comes to a head.

The two-price system is an outgrowth of directional drilling for gas. Its purpose is to assure a continued gas supply. The Commission frankly says that the adoption of the system for the Permian Basin "should serve to furnish a practical test of whether in fact it will result in bringing forth additional supplies." We find no persuasive reason why the test should not be made.

7. The Cost Information.

In arriving at the Permian Basin rates the Commission used many sources of cost information. These included responses to questionnaires sent to producers, the Census of Mineral Industries for 1958, the Chase Manhattan Bank's 1961 Annual Analysis of the Petroleum Industry, the World Oil Magazine, the Oil and Gas Journal, the Joint Association Survey,[31] and others. The producers attack these sources on many and varied grounds. The range of objections runs from hearsay evidence through deprivation of right of cross-examination to denial of procedural due process. To take up each of these objections would increase the length of this opinion to encyclopedic dimensions.

From the information so obtained the parties, the staff, and the Commission make many computations and reach many results. The assumptions, allocations, formulae, equations, averages, means, and massive calculations may intrigue a mathematician or statistician but they have no

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[31] This is a survey of a few producers conducted by the American Petroleum Institute, the IPAA, and the Mid-Continent Oil and Gas Association.

attraction for us. We respectfully decline to be drawn into such a turmoil of numbers. We cannot in a few months unravel the snarl of statistics developed in the years of hearings. In our opinion the judicial process, in cases such as this, should be confined to consideration of errors of law. We leave to the experts the selection of source material and the calculations to be made therefrom. Our concern is with the result.

8. The Commission's Price Determinations.

The Commission said that "costs must be a major factor in determining the area price." On the basis of current national statistics plus questionnaire data it determined the 1960 Mcf cost of new gas-well gas thus:

Exploration and Development Costs	
Dry Holes	1.42 cents
Other Exploratory Costs	1.59
Adjustments for Exploration in Excess of Production	1.11
Production Operating Expense	2.70
Net Liquid Credit	(3.10)
Regulatory Expense	.14
Depletion, Depreciation, and Amortization of Production Investment Costs	
Successful Well Costs	2.88
Lease Acquisition Costs	.76
Cost of Other Production Facilities	.31
Return of Production Investment (at 12%)	5.21[32]
Return on Working Capital	.35
Subtotal	13.37
Royalty at 12½ percent	2.05
Production Taxes	1.01
Total	16.43

[32] This is computed as follows: The production investment is the sum of successful well costs, lease acquisition costs, and cost of

The Commission rounded this figure off at 16.5 cents for the Texas production. Because the New Mexico figure is exclusive of taxes a reduction of one cent was made in the New Mexico price.

For the costing of flowing gas the Commission used historical data developed by the industry questionnaires. The results may be summarized thus:

Production operating expenses	1.75 cents
Depreciation, depletion and amortization	2.42
Return at 12%	4.99
Exploration and development	4.08
Regulatory expense	.14
	13.38
State Production tax at 7%	1.01
	14.39[33]

This figure was rounded off at 14.5 cents for Texas and 13.5 cents for New Mexico. As a check on the method used the Commission backtrended the new gas-well gas figures and arrived at a 14.64-cent price.

The rates so established are subject to downward adjustment because of quality deficiencies and to both downward and upward adjustments on the basis of Btu content. The Commission disclaims any intent that the rate figures show producer costs. It says that the price of new gas-well gas is "geared" to costs derived from national statistics and the questionnaire data and that for flowing gas

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other production facilities or a total of 3.95 cents. It is to be recouped over an average period of 10 years beginning an average of one year after investment. Accordingly, the return is allowed on an investment base 11 times the production investment of 3.95 cents per Mcf or 43.45 cents. 12% of this figure is 5.21 cents per Mcf.

[33] No separate item was included for royalty payments because costs were computed on 7/8 of actual volumes.

the "touchstone" is the historical price of Permian gas.[34] Other undefined and unidentified "factors" were taken into consideration.

9. **The Moratorium.**

The Commission implemented the price provisions of the decision in various ways. It imposed a moratorium on rate increases until January 1, 1968, "except in compliance with a specific order of the Commission for a rate as determined pursuant to said proceeding [AR61-1] or pursuant to later order of the Commission." The producers say this violates the Act because § 4 permits filings for rate increases. Section 4 must be read with other sections of the Act. Section 5 authorizes the Commission to determine the just and reasonable rate "to be thereafter observed and in force." Section 16 gives the Commission power to make such orders "as it may find necessary or appropriate to carry out the provisions of this act." In Callery the Court held that there was ample power under § 7(e) to impose a moratorium.[35] We believe that there is also ample power under §§ 5(a) and 16. The reasonableness of the exercise of the power is established by the need for price stability, the Commission's expressed willingness to reopen the proceedings to consider the propriety of changes, and the expiration date which is only about a year off.

10. **The Escalation Clauses.**

The Commission's order forbids the filing of rate changes in excess of applicable area rates when the contractual

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[34] In Opinion No. 468 the Commission said: "Nevertheless, we make clear that we do not confine ourselves to a cost calculation in determining just and reasonable rates."

[35] 382 U.S. 223, 228.

right thereto is based on indefinite escalation clauses not permitted by § 154.93(a), (b), and (c) of the Regulations under the Natural Gas Act. The producers say that this provision destroys existing contract rights. The Commission replies that it has not proscribed the clauses but merely the right to file under them. This is a thin distinction. In Pan American Petroleum Corporation v. Federal Power Commission, 10 Cir., 352 F. 2d 241, 245, we upheld § 154.93 and pointed out that if a producer felt aggrieved thereby it could apply for a rule waiver under § 1.7(b) of the Commission's Rules of Practice and Procedure. We assume that a similar request could be made under the Permian order. When the request is made and rejected, the time will arrive for the consideration of the constitutional questions which the producers raise.

11. **The Commission's Fair Relationship Standard.**

In fixing the amounts of the area rates the Commission rejected the end result test and adopted a fair relationship standard. This appears clearly from Opinion No. 468-A. After disclaiming that it had made any finding that "jurisdictional revenues will equate to jurisdictional costs," the Commission said:

> "* * * we are convinced that the record fully justifies the Commission's judgment that the ceiling prices we have fixed 'provide a fair relationship between the aggregate price the consumer pays and the aggregate costs that the producers incur' in the Permian Basin."

Hope says that in the fixing of just and reasonable rates there must be a "balancing of the investor and the consumer interests."[36] It goes on to say that from the company point of view the revenue must not only provide operation expense but also capital costs including "service on the debt and

[36] 320 U.S. 591, 603.

dividends on the stock"; and that the return to the equity owner must be commensurate "with returns on investments in other enterprises having corresponding risks" and "sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital."[37] The Court concluded the discussion of this problem with the observation that in Hope the "end result" could not be condemned as unjust and unreasonable.

In Colorado Interstate Gas Co. v. Federal Power Commission, 324 U.S. 581, 605, the Court, after referring to the Natural and Hope decisions said:

> "In those cases we held that the question for the courts when a rate order is challenged is whether the order viewed in its entirety and measured by its end results meets the requirements of the Act."

Also pertinent is the statement of the Court in Second Phillips that:[38]

> "To whatever extent the matter of costs may be a requisite element in rate regulation, we have no indication that the area method will fall short of statutory or constitutional standards. The Commission has stated in its opinion in this proceeding that the goal is to have rates based on the 'reasonable financial requirements of the industry' in each production area, * * * and we were advised at oral argument that composite cost-of-service data will be considered in the area rate proceedings."

Nothing in Second Phillips rejects the end result test of Hope. We believe that it applies here and that it is not satisfied by a finding of fair relationship. Something more than mere semantics is involved. The determination of a

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[37] Ibid.

[38] 373 U.S. 294, 309-310.

fair rate from the standpoint of the consumers must depend to large extent on the informed judgment of the regulatory agency. In these proceedings no distributor, consumer interest, or consumer representative objects to the rates. They are accepted as just and reasonable.

From the standpoint of the producer the situation is different. It is entitled to recover its prudent operating expenses and capital costs with a return commensurate to the risk and sufficient to attract capital. These requirements must be tested against the record. They may not be brushed aside with a general finding of fair relationship. The Commission concedes that it did not equate jurisdictional costs to jurisdictional revenues. This is obvious because no determination was made of the jurisdictional revenues which the rates will produce.

12. **The High Cost Operator and the Small Producer.**

The Commission broke down the rates into components which it justified on averages based on national statistics and questionnaire data. We recognize that weighted averages and sifted averages are suspect.[39] We accept the principle that both the basic figures and the averages obtained therefrom must be typical and representative but we are not convinced that the Commission has misused its expertise in this technical field. It is self-evident that when average costs are used to compute ceiling prices, the high cost operator will be hurt and some low cost operators may receive windfalls. Probably to a greater extent than in any other comparable segment of the national economy the element of chance can affect the success or failure of even the most prudent entrepreneur who engages in the natural-gas business.

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[39] See United States v. Abilene & Southern Railway Company, 265 U.S. 274, 291, and Interstate Commerce Commission v. Mechling, 330 U.S. 567, 583.

The problem of the high cost operator is characteristic of group or area rate making. The Supreme Court upheld group rates in Acker v. United States, 298 U.S. 426, 431, and commented that "regulation cannot be frustrated by a requirement that the rate be made to compensate extravagant or unnecessary costs." In Tagg Brothers v. United States, D.C. Neb. 29 F. 2d 750, 755, affirmed 280 U.S. 420, the court said that it was not necessary "to fix the rates so high that all agencies in the business would make money." Covington & Lexington Turnpike Road Company v. Sanford, 164 U.S. 578, 596, says that "the public cannot properly be subjected to unreasonable rates in order simply that stockholders may earn dividends."

The small producers, represented here by Big Chief Drilling Company, IPAA, Texas Independent Producers & Royalty Owners Association (TIPRO), J. C. Barnes, and others, join in the prediction that the Permian decision sounds the death knell of the small producers. Perhaps the flamboyant wildcatter must be replaced by the scientists of the industrial giants but the efforts of the boom-or-bust adventurers have contributed greatly to natural-gas discoveries. In its decision the Commission referred to the "smaller independent who traditionally drills much of the Permian exploratory acreage" and said that: "Consumers and the natural gas industry alike have a strong stake in the continuation of the exploration efforts of the thousands of small operators who contribute a large share of the discoveries of new sources of gas."[40]

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[40] Big Chief asserts that the small producers, although credited with only 20% of current production volumes, actually drill almost 40% of all successful gas wells and 50% of all successful exploratory gas wells.

The Commission took note of the suggestions that small producers should be exempt from regulation.[41] It found that outright exemption was neither necessary nor desirable but said that the small producers needed "special treatment." To this end it defined a small producer as "a natural gas company selling jurisdictionaly less than 10,000,000 Mcf annually on a nation-wide basis." They were granted relief from various requirements of §§ 7 and 4 and were freed from rate adjustments because of quality differentials. In our opinion the classification is reasonable and within the Act.

The small producers do not seek complete exemption. Their attitude is that such relief would be illusory rather than real because the pipelines would not pay more for gas supplied by them than the price paid to the major companies. Their complaint is that the Commission did not give adequate consideration to small producers' costs.

Data covering the costs of Permian producers came from questionnaires which are classified as Appendix B and Appendix C. The Appendix B group was mandatory for producers with company-wide jurisdictional sales of over 10 million Mcf and optional for others.[42] The Appendix C questionnaires went to the small producers. Forty-two of the majors and 25 of the small producers answered Appendix B. The response to the Appendix C questionnaires was sporadic. The Commission used only the material supplied by the majors saying that the inclusion of the data supplied by the small producers "does not affect the results."

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[41] See statements of Justice Clark dissenting in Second Phillips, 373 U.S. 294, 329-330, and speaking for the Court in Federal Power Commission v. Hunt, 376 U.S. 515, 527.

[42] Appendix A pertained to well and drilling statistics. It is not pertinent here.

TIPRO and Big Chief both emphasize the testimony of a staff witness that the small producer questionnaire showed average unit costs 2 cents per Mcf higher than those of the majors. They argue that the end result standards must be applied not only to the entire group but to them as a group. The weakness of the argument is that once the whole group is split the process can be carried on until the regulation is back on an individual company basis.

We do not know the answer to the small producer problem. Superficially it seems unfair to fix ceiling prices for all producers, both large and small, on the basis of the costs of large producers only. The Commission rejected the small producer data because in its opinion the impact on the rate structure was de minimis. On the record presented, we are unwilling to say that this conclusion was erroneous as a matter of law.

In any regulation of the natural-gas industry on an area basis the high cost producers, be they majors or little fellows, are certain to be placed in a position less advantageous than that occupied by those whose good fortune and able management have supplied a lower cost base. We agree with the Commission that the expense items included in an individual cost-of-service are not the measure of a confiscatory rate. A producer has no constitutional right to be reimbursed for dry-hole expenses.[43] Also it has no obligation to remain in business by replenishing the supplies of gas which form the basis of present obligations. Inability to continue exploration and development is not confiscation. We conclude that the impact of the Permian rates on the high cost producers does not destroy the area rate method.

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[43] Cf. Columbus Gas & Fuel Co. v. Public Utilities Commission of Ohio, 292 U.S. 398, 407.

13. **Gathering and Processing Costs.**

One subject of much discussion in the briefs is the allowance of the same rate for gas delivered at the tailgate of a processing plant and for gas delivered at the wellhead. Gathering lines cost money and have to be built and operated by someone. The Commission's position is that the revenues received for oil and oil products derived from condensation and processing return a profit which induces the building of the needed gathering lines and plants. Here again we reach the troublesome field of cost allocations between a regulated commodity, gas, and unregulated commodities, oil and liquified petroleum products.

Bass places particular emphasis on this phase of the case. It points to its extensive investments in gathering lines and plants and to its permanently certificated rate of 18 cents which, it says, the Commission has never specifically found unreasonable or discriminatory. The answer as we see it is that if area rates are proper no greater need exists for the consideration of the individual cost and revenue requirements in the case of Bass than in the case of the other producers. Perhaps in the future courts will have to explore the mysteries of allocations but we are not so inclined in this case. If in fact Bass and others similarly situated are confronted with confiscation, a way must be open for them to be heard.

14. **Special Exemptions.**

The Commission recognized that some provision must be made for special exemption from area rates. It said that when a producer's "out-of-pocket expenses in connection with the operation of a particular well are greater than the revenues under the applicable area price, he should be entitled to appropriate relief." It declined to "specify

all of the special circumstances which may serve as a basis for exceptions to the area rate" and observed that failure to earn exploration and development expenses plus the allowed return does not amount to confiscation. In regard to the form of relief it held that "it may be sufficient to permit them to abandon their unprofitable sales."

We agree with the Commission that an escape clause cannot be used to convert an area rate into an individual company cost-of-service rate but an escape clause which does no more than prevent an unconstitutional confiscation amounts to nothing. None is needed for that purpose. The producers are right in saying that the Commission's exemption provisions are so vague and nebulous that neither they nor a court can determine what relief is being granted. Out-of-pocket expenses are not defined and we do not know what they include. If a producer's accounting is on a lease rather than well basis, the facts relating to a particular well might not be determinable. It may be going too far to say categorically that individual producers should be permitted to show that the group costs are not typical or representative of their costs but in some instances that should be permitted. Conservation of gas is promoted if marginal wells are allowed to continue to produce but is discouraged if the same wells are shut down by a low price. Some producers furnish gathering facilities. Others sell at the wellhead and the pipelines pay for the gathering. Gathering costs are allowed pipelines. Perhaps in some instances they should be allowed to producers. An adequate savings clause should contain guidelines which if followed by an aggrieved producer will permit it to be heard promptly and to have a stay of the general rate order until its claim for exemption is decided. It is not enough to say in effect that confiscation will be prevented. Confiscation is an individual proposition and the individual is entitled

to be heard. We are convinced that the Commission's special exemption provisions are inadequate.

15. **Quality Standards.**

The Commission provided for adjustments in the area rates to reflect quality differentials. It said that "the price of gas cannot be related to volume alone but must be related to units of energy free of impurities and sufficiently compressed to enter the pipeline." Standards were fixed for content of carbon dioxide, hydrogen sulphide, total sulphur, water, and other impurities; and the amount of delivery pressure was established. The applicable base area rate is adjusted downward by the net cost of processing the gas to bring it up to standard. Provision is made for both an upward and a downward adjustment of rate depending on the Btu content. Quality statements are required to be filed together with an agreement by the seller and the buyer covering the cost of bringing the gas up to standard. If an agreement cannot be reached, each shall file a statement of its views on the processing costs.

About 90% of the flowing gas is substandard. We are cited to no figures on the similar percentage of new gas-well gas. The amount of the rate adjustments does not appear in the record because there was no evidence of the extent of quality differentials or of the processing costs of bringing the gas up to standard.[44] At oral argument various estimates were given as to the amount of rate reduction which would result from substandard quality. These were based on statements filed pursuant to the decision but after the record was closed. They ranged from .7 cents to 2.0 cents per Mcf. A spokesman for the Continental

[44] The Commission says in its brief that "appropriate price differentials or adjustments could not be made on the basis of the record."

Group said that on 1960 volumes a revenue deficiency of some $12 million a year would result. The Commission response in this court to the Skelly motion for stay of the Commission's orders herein said that the reductions in applicable rates because of adjustments for quality standards are expected to result in a revenue reduction of about $10 million annually.[45]

The producers' argument that the imposition of quality standards violates procedural due process because of lack of notice need not be resolved at this time. We are remanding the case and now everyone has notice. The matter of the Btu adjustments presents a particular problem which was emphasized by Commissioner O'Connor in his dissent. The price goes down if the Btu content is below 1,000 and goes up if it is above 1,050. The producers say the adjustment upward should begin at 1,000. We do not understand the Commission's reasons for the gap. On remand this can be clarified.

16. **The Rate of Return.**

The Commission says that the impact of the quality adjustments is taken care of in the rate of return which is made generous on this account. It fixed a rate of return of 12% on production activities and held that such rate "protects gas consumers against excessive prices but it is not so low that it fails to respond to the needs of the industry." The principles applicable to the determination of an appropriate return are set forth in Bluefield Water Works & Improvement Co. v. Public Service Commission, 262

[45] The statement was this: "It has been estimated that the reductions to the base rates alone will reduce the revenues from jurisdictional Permian sales by about $10 million annually. The adjustments for quality standards, which were substantially altered by Opinion 468-A * * * are expected to result in a further reduction of the same magnitude."

U.S. 679, 692-693. It "must be determined by the exercise of a fair and enlightened judgment, having regard to all relevant facts." The rates of a public utility should "permit it to earn a return on the value of the property * * * equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties" but the utility has no constitutional right to profits realized by "highly profitable enterprises or speculative ventures." The return should assure "confidence in the financial soundness of the utility" and be adequate under prudent management "to maintain and support its credit ad enable it to raise the money necessary for the proper discharge of its public duties." The Hope decision[46] states the same basic principles.

The Commission recognized these controlling principles. The objections of the producers are to the point that the allowed rate of return is inadequate to enable the industry to attain the goals which the principles contemplate. At this time there is no need for us to go into the comparisons of the returns appropriate for producers as opposed to pipelines or to the financing methods employed by either. The fact is that by treating quality deductions as a risk rather than a cost the Commission has made it impossible to determine the amount of return with any degree of certainty. The difficulty is that the record does not disclose the amount of deductions.

A fair rate of return cannot be ascertained with mathematical certainty.[47] Pragmatic adjustments may be made by an agency within the ambit of its statutory authority.[48]

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[46] 320 U.S. 591, 603.

[47] Colorado Interstate Gas Co. v. Federal Power Commission, 10 Cir., 142 F. 2d 943, 961-962, affirmed 324 U.S. 581.

[48] Federal Power Commission v. Natural Gas Pipeline Co., 315 U.S. 575, 586.

A court must put great reliance on agency expertise in evaluating a rate of return but this does not mean that a court must accept the agency determination in blind faith. A producer is entitled to a higher rate of return than a pipeline because of the greater risk of the business. The Commission has here compounded the risk of discovery with the risk of substandard quality.

We believe that the price reductions to reflect quality deviations are an item of cost rather than an item of risk and should be directly reflected in the applicable base rates instead of hidden in a rate of return allowance. The amount of cost is the expense of bringing the quality up to standard. In the Permian Basin sound reason exists for this conclusion because of the known and substantial quality deficiencies particularly in flowing gas production. We find it hard to understand why a revenue deficiency in the estimated amount of $10 million annually should be classified as a risk and not a cost. A risk occurs as the result of unknown or unconsidered contingencies. In the Permian Basin it is known and considered that flowing gas falls short of pipeline standards. In any event, the lack of evidence as to quality deductions makes it impossible to determine whether the rate of return satisfies the Bluefield and Hope principles and we have no basis on which to appraise the allowance made by the Commission. We respect the expertise of the Commission but the conclusions reached by the use of expertise must accord with legal standards.

17. Contract Limitations.

The producers say that recovery of industry costs under the area rates is impossible because many of the existing contracts do not permit a producer to file for the flowing gas ceiling price of 14.5 cents. The Commission recognized that "there undoubtedly will be some contract prices

lower than the area rate ceiling, as adjusted for quality." Some of the producers estimate the deficiency because of contract limitations to be $14.4 million in the test year of 1960. The Commission has estimated that a reduction of base rates alone will result in a revenue reduction of about $10 million annually.[49]

It is elementary that gas prices are originally set by contract between the producer and the pipeline, that the producer may not raise the price unilaterally, and that any increase in price must be within contract terms unless the price is set so low as to affect the public interest. The Commission says that the producers are not entitled as a matter of right to collect contract rates that are higher than otherwise reasonable in order to offset other rates limited by contract to below maximum reasonable levels. Regulation does not guarantee an over-all profit;[50] relief from an unduly low rate may be given only if the rate is "so low as to adversely affect the public interest — as where it might impair the financial ability of the public utility to continue its service, cast upon other consumers an excessive burden, or be unduly discriminatory";[51] and a company's losses in one instance do not justify an illegal gain in another instance.[52] At the same time in such group procedures as the division of railroad rates the Interstate Commerce Commission, with court approval, has recognized that revenue from one source may balance that from another.[53]

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[49] See supra, note 45.

[50] Federal Power Commission v. Natural Gas Pipeline Co., 315 U.S. 575, 590.

[51] Federal Power Commission v. Sierra Pacific Power Co., 350 U.S. 348, 355.

[52] Federal Power Commission v. Tennessee Gas Transmission Co., 371 U.S. 145, 153.

[53] See New England Divisions Case, 261 U.S. 184.

Contract limitations are one of the facts of life for the natural-gas industry. They are the outgrowth of the days when gas, which had previously been vented, flared, or capped, became salable to the newly constructed interstate pipelines. The pipelines wanted long-term contracts and the producers wanted to sell their gas. Prices were low. With the phenomenal increase in the use of gas as an energy source the prices rose. The producers whose contracts either contained no escalation clauses or clauses of the type proscribed by the Commission were in a disadvantageous position. Even permissible escalations do not, in many instances, bring the 1960 price up to the area ceiling. In Second Phillips the Court upheld the termination of certain § 4(e) dockets on the Commission's finding that "the annual increase in revenue produced by these increased rates was substantially less than the deficit for the test year 1954."[54] The same situation exists here for many companies. We do not know whether it exists for the area producers as a group because no finding was made of revenue and requirements. The Supreme Court has said that losses in one instance do not justify illegal gains in another. To us this means that the contract limitations do not preclude the establishment of a just and reasonable area rate. The answer is provision for a minimum rate.

The Commission held that "the establishment of minimum rates in this case is in the public interest and that the price impact on the consumer will be de minimis." It established a minimum rate of 9 cents per Mcf for gas of standard pipeline quality. We believe that the controlling question is whether the proper revenue requirements of the area producers as a group can be satisfied with rates having the ceiling and the floor which the Commission has fixed.

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[54] 373 U.S. 294, 305.

This cannot be answered because the financial impact of the quality deductions is not ascertainable from the record.

18. **Refunds.**

The revenue deficiency argument of the producers leads directly to the refund issue. The Commission required "appropriate refunds in the case of rates which are the subject of proceedings under Section 4(e) of the Act, and have thus been collected subject to an obligation to refund amounts collected in excess of the just and reasonable rates as here determined." Procedures to accomplish this result were set up in detail.

The producers say that these individual company refunds are not proper because of the revenue deficiency of the industry. They say that in the test year of 1960 the producers in the area failed to meet their revenue requirements by $14.4 million and they estimate the refunds for that year under the Commission decision to approximate $6 million.

The Examiner held that refunds should be ordered only to the extent that over-all industry revenues exceed over-all industry expenditures in a given year. The Commission said that this theory was unworkable because it would result in inequities among both the buyers and the producers and because of "insurmountable" administrative difficulties. We are at a loss to understand how refund obligations, which might come into existence under the Examiner's approach, would be divided among the producers.

We see no escape from the requirement that refunds be on an individual company basis and on a schedule by schedule basis. As we understand Federal Power Commission v. Tennessee Gas Transmission Co., 371 U.S. 145, 153, refunds are appropriate for each excessive rate re-

gardless of over-all revenues. The Commission has required refunds only on § 4(e) rate increases above the applicable area ceiling. If a producer claims that the refunds required of it are confiscatory or harmful to the public interest, it must have an opportunity to petition for special relief. A similar opportunity must be afforded if a producer can show that a refund is required for collections at or below the "last clean rate."[55] An adequate special exemption clause can take care of such situations.

19. **The End Result Test.**

This brings us back to the end result test. The Continental Group, which includes many large producers and major integrated oil companies and which is supported by Phillips, presents alternative arguments. The first is economic. It is said that regulation under the Act must be consistent with the economic characteristics of the industry; that this requires the establishment of market prices based on contracts; that a cost-based system of regulatory rates does not recognize the responsiveness of the gas supply to gas prices; and that a producer does not explore on the expectation of a return of its cost plus a return on its investment but on the hope of getting back many times what it expends as a reward for its gambler's risk. No doubt these are the economic facts of the industry.

The divorce of commodity value from costs was suggested by Justice Jackson in his dissent in Hope. He commented that a producer would have difficulty showing the invalidity of a fixed commodity value so long as it voluntarily continued to sell its product in interstate commerce.[56] One difficulty with this suggestion is that once the gas is

[55] By "last clean rate" is meant the last rate in effect pursuant to a permanent certificate not subject to any refund obligation.

[56] 320 U.S. 591, 652.

committed no withdrawal from interstate movement is possible without Commission approval.[57] A producer can stop exploration and development if it is dissatisfied with price but the interstate sales go on with a continuing impact of cost on price and of price on exploration and development. In any event the majority rejected the proposal and held that under the just and reasonable standard of the Act a regulated company is entitled to revenue for operating expenses and capital costs and to a return "commensurate with returns on investments in other enterprises having corresponding risks."[58] These standards cannot be met without consideration of costs and revenues. In our opinion the Hope construction of the statutory standard casts serious doubts on the validity of the adoption of a contract-based commodity value.

The alternate argument of the Continental Group is that if the rates are to be determined on a composite cost-of-service basis, the revenue requirements of the industry must be found and rates fixed to meet those requirements. In Second Phillips the Court particularly noted the assurance of the Commission that "composite cost-of-service data will be considered in the area rate proceedings."[59] Consideration of such data does not eliminate consideration of other factors. At the same time Second Phillips did not reject the end result test of Hope. Instead it quoted a portion of that opinion which said among other things that "it is the result reached not the method employed which is controlling."[60]

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[57] Section 7(b) of the Act. See also Sunray Mid-Continent Oil Co. v. Federal Power Commission, 364 U.S. 137, 156.

[58] 320 U.S. 591, 603.

[59] 373 U.S. 294, 310.

[60] Id. at 309.

The Commission rejected both alternatives of the Continental Group. It said that commodity value established by contracts may not be used because of the absence of effective competition; and it emphasized that it took into consideration factors other than costs. The record does not disclose what these other factors were but they must have had some economic basis. The Commission held that its ceiling prices provided a "fair relationship" between consumer prices and producer costs. Fair relationship is pertinent but it is only part of the end result test. We do not know the producers' costs or revenue requirements. We do not know the economic factors which either require or permit departure from costs and revenues. The end result test is not satisfied by a reliance on unknowns.

We have accepted the Commission's conclusion that contract rates should not be used. The trouble is that the Commission decision rides two horses and we have no way of knowing the outcome of the race. It uses composite cost-of-service evidence, engrafts economic factors on top, and comes out with a rate which it justifies on a fair relationship basis. We have the problem of how in such circumstances a court can determine whether the just and reasonable standard of §§ 4 and 5 has been met. The answer is not found in the record before us.

The facts sustaining the conclusion of fair relationship must be found. The Commission did not make those findings and indeed it could not have done so because of the failure of the record to disclose the revenue impact of the adjustments in area rates to reflect quality differentials. Whether rate reductions because of quality deficiencies are a risk or a cost, the answer comes out the same. If they are a risk, we do not know the rate of return. If they are a cost, we do not know whether revenue received will equal the reasonable revenue requirements. We believe

that under Hope, and under Second Phillips, the area producers, as a group, are entitled to recover their prudent operating expenses and capital costs with a return commensurate to the risk and sufficient to attract capital. Satisfaction of this requirement must appear through appropriate findings based on substantial evidence. These cannot be made on the record presented. The decision of the Commission is not saved by the special exemption provisions which we find to be insufficient and unsatisfactory.

Rate making under the Act has produced a superabundance of delay and litigation. Much gas has moved through the pipelines since the First Phillips decision. We wonder if the time has not come for the establishmnt of a better rapport among the Commission, the consumers, the distributors, the pipelines, and the producers. Some practical means of resolving the economic and legal issues is highly desirable. The Commission has approved many settlements. The use of this procedure may well be explored further in an effort to obtain a true "balancing of the investor and the consumer interests."[61]

One point remains to be mentioned. Eleven motions for leave to adduce additional evidence were filed with us by various producers. We deferred all to the hearing on the merits. In view of the disposition which we make of the cases we see no reasons to explore evidentiary problems which may arise on remand. The Commission will hold such additional hearings as are needed to determine the effect of the quality adjustments, and to determine the group revenues and the group revenue requirements. It will make appropriate findings on these matters. The order based thereon shall contain an adequate provision for special ex-

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[61] 320 U.S. 591, 603.

emptions. We decline to make advance rulings on the procedures to be followed or on the evidence to be received.

The motions to adduce additional evidence are severally denied. The petitions to review are severally granted and the cases are all remanded to the Commission for further proceedings consistent with this opinion.

Judgment

THIRTEENTH DAY, JANUARY TERM,
FRIDAY, JANUARY 20TH, 1967.

Before Honorable David T. Lewis, Honorable Jean S. Breitenstein and Honorable Delmas C. Hill, Circuit Judges.

No. 8510

THE SUPERIOR OIL COMPANY,
Petitioner,

v.

FEDERAL POWER COMMISSION,
Respondent.

On Petition to Review an Order of the Federal Power Commission.

This cause came on to be heard on petition to review an order of the Federal Power Commission and motion to adduce additional evidence and was argued by counsel.

On consideration whereof, it is ordered by this court that the motion to adduce additional evidence is hereby denied. The petition to review is granted and the case is remanded to the Commission for further proceedings consistent with the opinion of the court.

PETITION FOR A WRIT OF CERTIORARI

APR 18 1967
JOHN F. DAVIS, CLERK

IN THE

SUPREME COURT OF THE UNITED STATES

January Term, 1967

NO. ~~1291~~ 98

STATES OF NEW MEXICO AND TEXAS,
Petitioners

v.

FEDERAL POWER COMMISSION,
Respondent

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

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IN THE

SUPREME COURT OF THE UNITED STATES

January Term, 1967

NO. ——

STATES OF NEW MEXICO AND TEXAS,
Petitioners

v.

FEDERAL POWER COMMISSION,
Respondent

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

The States of New Mexico and Texas, Petitioners in the above styled case, respectfully pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Tenth Circuit entered on January 20, 1967.

OPINIONS BELOW

The opinion of the Court of Appeals for the Tenth Circuit is styled *Skelly Oil Company, et al., Petitioners, v. Federal Power Commission, Respondent,* Nos. 8385, *et al.* A copy of the Court decision is printed as Appendix A to the brief of Petitioner, Continental Oil Company. The opinion and orders of the Federal Power Commission (R. 516d-826d, 1105d-1132d, 1154d-1157d) are reported at 34 FPC ————, ———— ————, ————.

JURISDICTION

The jurisdiction of this Court is invoked under 28 USC § 2101 and Rule 19 of the Rules of this Court. The judgment of the Court of Appeals was entered on January 20, 1967.

QUESTIONS PRESENTED

1. Whether the Federal Power Commission, in fixing producer rates under the Natural Gas Act, is required to protect the public interest of producer states as well as consumer states?

2. Whether the Federal Power Commission, in fixing producer rates under the Natural Gas Act, is required to consider the economic import of its orders on the producing states involved?

3. Whether the Federal Power Commission, in fixing producer rates under the Natural Gas Act, is required to consider the impact of its orders on the conservation efforts of the producing states, ie. whether its orders will result in waste of recoverable natural gas reserves.

4. Whether the Federal Power Commission, in fixing producer rates under the Natural Gas Act, is required to make an express finding that the rates established by its orders will elicit a level of exploration and development high enough to assure an adequate supply of natural gas for the future.

STATUTES INVOLVED

The Natural Gas Act, 52 Stat. 821 *ff.*, 15 USC § 717-717w.

PRELIMINARY STATEMENT OF POSITION

These Petitioners support the arguments and points presented and set out in the Continental Oil Company's Petitioner for a Writ of Certiorari heretofore filed with this Court. In addition thereto, it is the position of these Petitioners that they are affected in their governmental capacity by the subject orders of the Federal Power Commission and that the questions presented above must all be answered in the affirmative.

INTRODUCTION

These Petitioners, recognizing that an area rate hearing establishing prices for natural gas in the Permian Basin would have a far reaching effect, not only on the Permian Basin area itself but on the economy of the entire states, intervened in the Permian Basin Hearing, and actively participated in the hearings before the Federal Power Commission, the Denver Court and have now appealed to this Court as sovereign states, on behalf of their citizens and in order to protect the public interest.

While these Petitioners do not drill or operate any gas wells in the Permian Basin or elsewhere it is contended that they nevertheless have standing to challenge the rates established by the Commission because of the adverse effect of the same upon the States of New Mexico and Texas. In fact, these states are in all probability damaged by these orders in a greater dollar amount than any other party to these proceedings.

These Petitioners would show that the State of Texas has over 4.7 million acres of minerals located in the Permian Basin area and that the income royalties and

bonus money from these minerals go into the Permanent School Fund for educational purposes. Likewise, Petitioner State of New Mexico owns more than 3 million acres of mineral lands located within the Permian Basin and the royalties and bonus money derived from these minerals go into its school fund.

These Petitioners have imposed certain taxes upon the production of natural gas within their boundaries. This is done in recognition of the fact that natural gas like other natural resources is a wasting asset, and once produced and transported to other states for consumption, its value is forever lost. This tax is calculated upon the value of the gas at the well, and it is axiomatic that any reduction in its value will necessarily result in a reduction of the taxes received by these Petitioners.

There are many communities in the State of New Mexico which depend almost entirely on the oil and gas industry for their existence, and accordingly the State has an abiding interest in maintaining the future existence of this industry.

Without the oil and gas industry, a quarter of New Mexico's population could vanish and be forever lost. Such a calamity would cost the State untold millions of dollars.

More than one million Texans live in the Permian Basin area today, and, without a healthy petroleum industry, this population cannot be supported.

Testimony of witnesses for the State of Texas reflects that the Permian Basin area does not readily lend itself to manufacturing, and the majority of manufacturing in the area is tied to the petroleum industry.

Agriculture in the area is mostly confined to ranching, and even if the climate were more favorable, agriculture could not provide the jobs afforded by the petroleum industry.

The rates set by the Commission in the instant case have an adverse impact on the conservation efforts of the States of New Mexico and Texas. This comes about by virtue of the fact that the Commission established rates are considerably lower than existing contract rates in the area. This reduction makes it uneconomical to continue production in many "stripper fields" in the area.

Although daily per well production from these fields is relatively low, their combined remaining recoverable reserves nevertheless constitute a considerable percentage of the total reserves for the area which will be forever lost if it becomes necessary to plug and abandon these fields for economic reasons.

Another adverse result of the rate reduction ordered by the Commission is the corresponding reduction in exploration and development that will inevitably result. Even under the higher existing contract rates, the historical level of exploration and development has been insufficient to keep pace with the ever increasing consumer demand for natural gas. A shortage of gas will inevitably result, and, because of the considerable time lag between initial exploratory efforts and ultimate discovery and production of substantial new gas supplies, such a shortage cannot readily be corrected. Such a situation is undesirable from a conservation standpoint since the pressures of crash efforts to meet excessive demands inevitably result in both physical and economic waste.

ARGUMENT

The Commission failed to meet its statutory responsibilities to assure adequate supplies of natural gas for the nation and to protect the interest of the public (which includes the producing states as well as the consumer states). As clearly stated in 15 U.S.C.A. Section 717 (a):

> ". . . it is declared that the business of transporting and selling natural gas for ultimate distribution to the public is affected with a public interest, and that Federal regulation in matters relating to the transportation of natural gas and the sale thereof in interstate and foreign commerce is necessary in the public interest."

These Petitioners reiterate that the "public interest" requires the Commission to consider the effect of its order and opinions upon producing states as well as upon consumer states. Certainly, the interest of producing states is a part of the "public interest" and should not be ignored. A decrease in the price of gas of several pennies per Mcf, as ordered by the Commission, would hardly be noticeable to the average consumer in California and in other areas outside of Texas and New Mexico. At most, such a decrease would effect a savings to the average California home owner of only a few dollars a year. However, such a decrease in gas prices as required by the subject opinions and orders could not only place a large number of both large and small independent producers in New Mexico and Texas out of business because of their inability to meet expenses with the resulting lowering of income, but it could also have a serious impact upon every citizen of Texas and New Mexico. In short, an insignificant savings of a few dollars a year for the average

gas consuming family in California and in other areas outside of these producing states is in issue while for the many large and small independent producers throughout the Permian Basin area industrial survival is at stake. When the natural gas industry loses its independent producers through governmental interference with contract prices, the industry also loses their exploratory efforts; and, in the long run, the consumers throughout the nation will suffer for lack of supply, and, in addition the producing states will lose an indispensable source of tax revenue. Through loss of revenue to these States in the form of royalty payments and production taxes, the state school funds, and indeed many other portions of the States income, will be substantially lowered, which in turn could well result in these States' citizens bearing the burden of additional taxes in order to offset such revenues losses. Thereby, in effect, the citizens of Texas and New Mexico would be subsidizing the users of Permian Basin produced gas in other States. Such is the overriding, all important concern of these States.

The Legislatures of both the States of New Mexico and Texas long ago enacted comprehensive oil and gas Conservation Codes. These codes strenuously enforced by the Conservation Commission of New Mexico and the Texas Railroad Commission, both highly respected administrative agencies which have under their combined charge and supervision the greater part of the known natural gas reserves in the United States of America. The successes that they achieve in preventing waste are enjoyed not only by their respective States but by the entire nation. The efforts of these agencies are truly in the public interest—the interest of all the public, not just one faction.

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The reduced rates established by the Commission will result in the premature abandonment of many "stripper fields" in New Mexico and Texas. The remaining reserves in these fields will be wasted and forever lost to both producers and consumers.

Thus a conflict has arisen between the efforts of the Federal Power Commission and the Conservation Agencies of the States of New Mexico and Texas. This is true despite the fact that the agencies on both sides of this conflict have as their stated purpose the protection of the "public interest."

It is submitted that the public has a greater interest in the conservation of the nation's natural gas reserves than it does in prepetrating the lowest possible gas rates to the consumer and that if and when these two public policies should come into conflict, the latter must give way to the former.

The Tenth Circuit Court of Appeals in this case rejected these arguments when it stated:

> "The states of Texas and New Mexico, besides adopting the briefs and arguments of the Continental Group, assail the Commission decision on grounds peculiar to them in their governmental capacity. They say that the public interest, which the commission is required to protect, includes the producing states as well as the consuming states; that the prices which the Commission has set will cause a cessation or curtailment of exploration and development activities to the serious injury of the economy of the Permian Basin; that waste rather than conservation of a natural resource will result; and that the states and their public entities will suffer severe losses in taxes and royalty payments. Similar arguments were made by West Vir-

ginia in Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 607-614, and were rejected by the Supreme Court which said that when Congress passed the Natural Gas Act it 'was quite aware of the interests of the producing states in their natural gas supplies' and that nothing in the Act intimates that high prices should be maintained so that 'the producing states obtain indirect benefits.' The rejection of the states contentions in Hope requires the rejection of the same contentions here."

Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, has been cited as authority that the Commission in setting the price of gas at the wellhead cannot consider the economic impact its order will have upon the producing states.

Granted that West Virginia's argument in the *Hope* case is in some respects similar to the position taken by the States of Texas and New Mexico in the Permian case now before the Court, the *Hope* case is nevertheless distinguishable on its facts and cannot serve as a precedent in this case.

The *Hope* case arose from an original complaint filed in 1938 by two consumer cities alleging that Hope's charges were excessive and "unjust and unreasonable." Hope was primarily an interstate transporter and marketer of natural gas. The FPC reduced the rates charged by Hope as excessive. The court properly used the statutory standard of justness and reasonableness, saying at 320 U.S. 602:

> "If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at an end."

In this case however, the just and reasonable standard is not the only criterion. The Commission is now not only establishing rates to be collected under existing contracts but initial rates to be certificated under Section 7 of the Natural Gas Act. Thus it must establish initial rates not on the "just and reasonable" standard under Sections 4 and 5 but "in keeping with the public interest" under Section 7(e) of the Natural Gas Act. Surely the "public interest" is sufficiently broad to also encompass the interest of that portion of the public who lives in the States of Texas and New Mexico.

The *Hope* case was decided in January of 1944, ten years before *Phillips Petroleum Co. v. Wisconsin,* 347 U.S. 672, which pronounced the Federal Power Commission's jurisdiction to set the price of gas at the wellhead. In the *Hope* case the Supreme Court was reviewing the order of the Commission in fixing the rate of return and cost of service for one interstate pipeline company and not the wellhead price for gas to producing companies in a large geographic area. In the present case it is the gas producers who are being regulated while at the time of the *Hope* case they were completely exempt from Federal Power Commission regulation. The wellhead price of gas was not even involved in the *Hope* case. There the Commission and the Court were concerned with what should be included in the cost of service of Hope in order for it to realize a reasonable rate of return. The court remarked in passing that "the Federal Power Commission was given no authority over the production or gathering of natural gas" 320 U.S. 611, which indicates the extent of the evolution of this field of law since 1944.

Another distinguishing factor is that in the *Hope* case the impact on West Virginia was indirect and relatively insignificant, whereas in this case the impact on New Mexico and Texas is direct and greater in amount than on any other party in the case.

It must be realized that the interest of the producing states is going to have a direct effect on the interest of the consumer states and both interest must be given weight in determining wellhead prices for gas.

These Petitioners respectfully submit that any language in the *Hope* case which might be construed as preventing the Commission from considering the producing states as being "a part of the public interest" should be clarified or reversed, and that the court set down guidelines for the Commission to follow to insure equal protection of the interests of the producing states with those of the consumer states.

WHEREFORE these Petitioners respectfully pray that the Court grant a Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit to review the questions presented herein.

Respectfully submitted,

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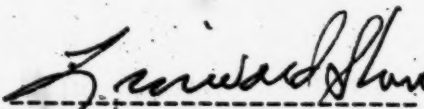
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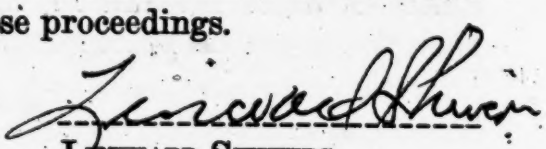
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PROOF OF SERVICE

I, Linward Shivers, attorney for Petitioners herein, and a member of the Bar of the Supreme Court of the United States, hereby certify that, on the 14th day of April, 1967, I served copies of the foregoing Petition for a Writ of Certiorari on Richard Solomon, Attorney for the Federal Power Commission, by mailing a copy in a duly addressed envelope, first class mail, postage prepaid, at the Federal Power Commission, Washington, D. C. I have further furnished a copy of this Petition for a Writ of Certiorari to all the other parties of record in these proceedings.



LINWARD SHIVERS
Assistant Attorney General

PETITION FOR A WRIT OF CERTIORARI

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1966

No.

SUN OIL COMPANY, *Petitioner,*

v.

FEDERAL POWER COMMISSION, STATE OF CALIFORNIA jointly with PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, CITY OF LOS ANGELES, CITY OF SAN DIEGO, CITY AND COUNTY OF SAN FRANCISCO, PACIFIC GAS AND ELECTRIC COMPANY, PACIFIC LIGHTING SERVICE AND SUPPLY COMPANY jointly with SOUTHERN CALIFORNIA GAS COMPANY and SOUTHERN COUNTIES GAS COMPANY OF CALIFORNIA, SAN DIEGO GAS AND ELECTRIC COMPANY, *Respondents.*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Tenth Circuit in this case entered on January 20, 1967.

OPINIONS BELOW

Opinion No. 468 of the Respondent, Federal Power Commission (hereinafter termed "Commission") (J.A. X/516d-XI/826d)[1] is reported at 34 F.P.C. 159. Opinion No. 468-A (J.A. XI/1105d) is reported at 34 F.P.C. 1068. The opinion of the Court of Appeals, printed in Appendix A hereto, *infra*, pp. 1a-44a, is reported in — F. 2d —.

JURISDICTION

The judgment of the Court of Appeals for the Tenth Circuit was entered on January 20, 1967 (Appendix B, p. 45a). This Petitioner filed no petition for rehearing with the court below; however, petitions for rehearing filed by other parties below are pending before that court.

The jurisdiction of this Court is invoked under Section 19(b) of the Natural Gas Act [15 U.S.C. § 717r(b)] and Chapter 81 of the Judicial Code, 28 U.S.C. § 1254.

QUESTIONS PRESENTED

By its Opinion No. 468 the Commission purported to determine just and reasonable rates for the first time on a group basis. The rates fixed by the Commission were predicated on averages of costs derived from a number of sources. The Court of Appeals for the Tenth Circuit affirmed the group method of fixing rates and the averages employed by the Commission, but set aside the opinion because there was no finding that group revenues would equate to group costs and no adequate "savings clause" provision whereby individuals in the group could, upon proper showing, be exempted from the group rates. The questions presented by this petition are:

(1) Whether the Federal Power Commission can fix just and reasonable rates under Sections 4 and 5

[1] "J.A." references are to the joint appendix in the court of appeals. Roman number references are to the volume number and arabic number references are to the page.

of the Natural Gas Act by a group method which wholly ignores the inability of individual producers to recover their operating expenses and capital charges at the rates fixed.

(2) Whether the court below, having properly accepted the fundamental principle that group rates must be based on evidence which is typical and representative, can lawfully affirm the use of basic data and averages which the Commission did not find to be typical and representative.

(3) Whether agency expertise is a proper substitute for requisite Commission findings that the basic data and averages it used were typical and representative.

(4) Whether the court below could lawfully refuse to decide due process questions arising from the lack of evidentiary standards and the Commission's subsequent use of data which could not be cross-examined or rebutted on the ground that the court should confine its consideration to "errors of law".

(5) Whether the Court below erred in its advisory statement that the Commission could constitutionally exclude from an individual company's cost of service legitimate expenses such as those incurred in drilling dry wells in the search for natural gas.

STATUTES INVOLVED

The statutory provisions involved are Sections 4 and 5(a) of the Natural Gas Act [15 U.S.C. §§ 717(c) and 717 (d)(a)] and Section 7(c) of the Administrative Procedure Act [5 U.S.C. § 1006(c)]. They are printed in Appendix C hereto.

STATEMENT OF THE CASE

1. History of Producer Rate Making

These proceedings are another chapter in the Federal Power Commission's efforts to fix just and reasonable rates under the Natural Gas Act [15 U.S.C. §§ 717-717(w)] for the sale of natural gas for resale in interstate commerce by independent producers. The Commission's jurisdiction over independent producers was determined by this Court in the *First Phillips* case, *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672 (1954). The Commission thereupon initiated efforts at regulating producer rates without having first announced standards for its regulation. When the producers undertook to support their rates, however, the Commission dismissed their presentations. On appeal, these dismissals were reversed with the direction that the producers be allowed the opportunnity to support their rate increase application with a cost showing at least as a point of departure, *Bel Oil Corporation* v. *Federal Power Commission*, 255 F. 2d 548 (5th Cir. 1958), *cert. den.*, 358 U.S. 804.

The Commission then turned to an individual company cost method of fixing rates. A number of such proceedings were disposed of by Commission approval of settlement agreements, and only one major company-wide cost case reached Commission decision, *Phillips Petroleum Company*, 24 F.P.C. 537 (1960). In that case the Commission found that Phillips' current prices were fully justified by its costs (24 F.P.C. at 546), and dismissed its investigation of those prices. Nevertheless, the Commission found that the method of finding costs it had used was unworkable and indicated that it was establishing a new approach to producer rate regulation based on industry financial requirements rather than individual producer costs. In its concurrent *Statement of General Policy No. 61-1*, 24 F.P.C. 818 (1960), the Commission preliminarily established geographical pricing areas and price standards to be used as

a guide in issuing certificates of public convenience and necessity and in suspending rate increase filings.

An appeal was taken to the Commission's *Phillips* rate decision. In argument before this Court in the *Phillips* case, the petitioners therein contended that the Commission had erroneously relied on its intention to institute area rate proceedings as its reason for dismissing its investigation of Phillips' prices and not proceeding to a final determination of just and reasonable rates in that case. In a 5-4 decision this Court upheld the Commission in the *Second Phillips* case, *Wisconsin* v. *Federal Power Commission*, 373 U.S. 294 (1963). The majority held that "the lawfulness of the area pricing method * * * [was not itself] before the Court for review" (373 U.S. at 308). The majority also found, however, that it had "no indication that the area method will fall short of statutory or constitutional standards" (373 U.S. at 309). The dissent expressed serious doubts of "both the wisdom and the legality of this approach to price determination * * *" (373 U.S. at 327), and noted that it was "* * * both premature and dangerous to pass any judgment at this stage of the proceedings" (373 U.S. at 326).

2. The Instant Proceedings

The Commission instituted the Permian Basin Area proceedings here under review by order issued December 23, 1960 in Docket No. AR61-1 (24 F.P.C. 1121) (J.A. IX/1d). Prior to the commencement of hearings the Commission ruled that it would not permit cost of service studies on either an individual or group basis (J.A. IX/29d). Thereafter, however, the Commission on August 2, 1961 (J.A. IX/38d), ordered the filing of cost data in response to questionnaires sent out to 458 out of the some 2,600 Permian producers (J.A. IX/75d, 79d). The Commission then reversed its prior ruling excluding any cost of service study and provided that it would permit cost of service studies on

a composite basis. Cost of service studies on an individual basis were still to be excluded, however (J.A. IX/68d).

Of the 458 questionnaires sent out, 173 responses containing cost data were received and of these 136 were used by the Commission staff to obtain averages. The Commission made only minimal efforts to obtain more complete and usable data (J.A. III/1068-70, IV/1150-1).

At the hearing, the individual responses to the Commission questionnaires were not made a part of the record and were not sponsored by the company personnel who prepared them. Instead, the data in the responses were totaled and presented in composite form by Commission staff witnesses. These witnesses, however, were unable to explain patent inconsistencies on the face of the data which made the data incapable of being composited. Also, the staff witnesses were wholly unable to testify as to the accuracy of the data reported by the individual companies in the questionnaire responses or to be cross-examined thereon.

Because of the lack of representativeness of the basic data and the inability to cross-examine such data, Petitioner, during the course of hearing, moved that the composites of the questionnaire responses be stricken. Also, Petitioner moved that the proceeding be dismissed by reason of this failure of proof and the basic unlawfulness of the group method as it was being undertaken. Shortly after the hearing ended, Petitioner sought to submit evidence previously unavailable which further showed that the basic data was incompatible and, hence, could not be composited. This added evidence was a summary of responses to a counter-questionnaire in a subsequent area rate proceeding which showed extensive disagreement among producers in the instant case as to the meaning of certain key questions in the Commission's questionnaires. The record was not reopened to receive this evi-

dence; the Commission never ruled on Petitioners' motion to strike and dismiss, and the composited responses formed the basis for the rates ultimately fixed.

Petitioner also sought, during the course of the hearings, to submit its individual cost of service in support of its current rates and in rebuttal to the staff presentation. This was rejected as were the presentations of other producers which had sought to make similar showings (J.A. III/1080-1, V/1905-6). In addition, Petitioner's counsel was not permitted to cross examine an array of individual costs of service submitted by a Commission staff witness to the extent such cross-examination would have disclosed the identity of individual companies which had not been revealed on the array (J.A. IV/1145-9, 1167-9).

3. The Commission's Opinion

The Commission's Opinion No. 468, issued August 5, 1965, adopted a two-price system of ceilings on the rates for gas produced in the Permian Basin. In fixing the ceiling price for old gas (gas contracted for prior to January 1, 1961), the Commission used a weighted average derived from only some 40 of the 136 questionnaire responses the Commission staff had composited. No findings were made as to the representativeness and typicality of the averages, however, and only very limited findings were made as to the representativeness of the questionnaire data which was used. Notwithstanding these latter findings, the questionnaire data was otherwise rejected as unrepresentative.

The Commission claims to have achieved representativeness for the questionnaire data by excluding from its consideration cost data filed by some 107 small producers and by rejecting cost data on the production and processing of casinghead gas which is produced in conjunction with oil. The result of the Commission's limited efforts to obtain basic data and its rejection of much of the data that was

obtained was that the purported historical cost of all gas flowing in the Permian Basin Area was computed from data obtained from some 40 out of 2,600 producers and covered only 15% of total production in the area.

In using weighted averages without finding that the result was typical or representative, the Commission ignored holdings of this Court that weighted and unsifted averages are suspect. In addition the Commission ignored the unrebutted testimony of a professional mathematician submitted by Petitioner who testified that in view of the extreme dispersion of the basic data it is unlikely that average costs could be obtained which would be representative within usuable limits (J.A. V/1624, 1626-7).

Weighted averages of data from the questionnaire responses were also used, along with other data sources, in deriving the basis for the new gas price fixed in Opinion No. 468. The other data sources used included the Census of Mineral Industries and trade journal, bank, and industry association surveys. None of this data was supported by witnesses who could testify either to the basic figures or the compositing of them. Additionally, the standard for the Commission's selection of the data sources is undefined and apparently non-existent since both the questionnaire responses and one of the industry surveys were variously rejected as unrepresentative, but otherwise extensively used.

After finding what purported to be group costs as noted above, the Commission fixed ceiling prices for old gas and for new gas based upon such costs. Admittedly, however, group revenues from such prices would not recover group costs. This was due to certain quality differentials by which the prices were reduced and the presence of contract limitations which would not permit producers to collect up to the ceilings. Also, the costs found did not allow for gathering and processing costs of the producers. In addition, the only opportunity provided the individual to show the im-

pact of the rates found, *i.e.*, whether these rates would permit his recovery of costs, was by a proviso that at some time in the indefinite future, individuals would be allowed to show that "out-of-pocket costs" were not being recovered as the basis for rate relief or abandonment of service.

4. The Proceedings on Appeal

Following issuance of Opinion Nos. 468 and 468-A, individual appeals were taken pursuant to Section 19(b) of the Natural Gas Act [15 U.S.C. § 717r(b)] by Petitioner and a large number of other producers, as well as by the States of Texas and New Mexico. The appeals were heard by the Court of Appeals for the Tenth Circuit in view of the first filing of a petition for review with that Court by Skelly Oil Company, located in that Circuit. Other appeals were subsequently transferred to the Tenth Circuit pursuant to the provisions of 28 U.S.C. 2112(a), or were filed therein by acquiescence of the Commission.

In its appeal Petitioner pointed out that from a constitutional and statutory standpoint rates fixed pursuant to the Natural Gas Act must be just and reasonable as to the individuals regulated. With this the case, Petitioner argued that group rate making was not appropriate under this statute as this Court had previously found in *Bowles* v. *Willingham*, 321 U.S. 503, 517 (1944). In any event, however, Petitioner pointed out that in accordance with the minimal constitutional and statutory criteria set forth in a long series of cases under the Natural Gas Act, the rates fixed must afford individuals regulated the opportunity to recover their operating expenses and capital charges. In accordance with the holding of this Court in the *New England Divisions* case, *Akron, C. & Y. R. Co.* v. *United States*, 261 U.S. 184 (1923), Petitioner showed that if group rate making were found to be necessary (which Petitioner disputes), evidence of the group used in fixing rates must be typical and representative of the individuals in the group.

Also, the individual must be afforded the opportunity to rebut any claim that the group evidence used is typical and representative as to itself and to except itself from the group rates on proper showing.

With respect to Opinion No. 468, Petitioner showed that the Commission had failed to give any consideration to whether individuals could recover their operating expenses and capital charges at the rates fixed and in fact on the face of the record a large number of producers could not recover such costs. Also, the Commission failed to make proper findings of typicality and representativeness of the basic data and the averages derived therefrom and failed to allow individual cost of service presentations. This precluded rebuttal to the basic data used and to the matter of typicality and representativeness. In addition it denied individuals the opportunity to make a showing upon which to except themselves from the rates fixed. Petitioner also showed that, by reason of many due process errors arising from the use of evidence that could not be cross-examined or rebutted and the failure to fix or follow regulatory standards, such findings as were made were not supported by reliable, probative and substantive evidence as required by Section 7(c) of the Administrative Procedure Act, 5 U.S.C. § 1006(c).

5. The Determination of the Court Below

The court of appeals decision issued January 20, 1967 remands the case to the Commission because the Commission failed to equate group revenues to be achieved with group costs found. This, the court holds, is not in accord with the "end result test" of *Federal Power Commission* v. *Hope Natural Gas Company,* 320 U.S. 591 (1944). In addition, the Court recognizes that the individual must be afforded the opportunity to show the impact of the rates fixed on itself, and remands the proceeding to the Commission for the development of definitive standards and a

tangible procedure by which the individual may make such a showing.

With respect to the fundamental question of the Commission's power to enter upon group rate making, the court holds that the Commission has such power, apparently based on an impression derived from the Commission that this method is required by the necessities of procedure and administration (App. A, pp. 16a-19a). The opinion does not relate the power to fix group rates directly to the fundamental constitutional and statutory proposition that the individual must be afforded the opportunity to recover its operating expenses and capital charges. Nevertheless, the court does recognize that costs must be typical and representative both as to the basic data and the averages obtained therefrom (App. A, p. 29a).

Despite its recognition that the typical and representative criteria are applicable and that weighted averages are suspect in making typical and representative determinations, the court below does not discuss Petitioner's contentions that there were no adequate findings of the typicality and representativeness of basic data and averages and no support for such findings that were made. Rather, the court below relies wholly on the expertise of the Commission in this regard. (App. A, p. 29a). This complete acceptance of the Commission's "expertise" is apparently part of the court's refusal to review a number of important evidentiary issues such as the Commission's reliance on hearsay evidence, the deprivation of the right of cross-examination, and other matters of procedural due process. To consider these issues, the court states, would increase its opinion to "encyclopedic dimension" and draw it into "a turmoil of numbers." Therefore, the court below confines its opinion only to what it terms "errors of law" (App. A, pp. 22a-23a).

Like the case of the typical and representative criteria the court of appeals also renders ineffectual its determina-

tion that the individual must be afforded the opportunity to make an individual showing. While providing that an escape clause for the individual must do more than protect against unconstitutional confiscation and must be specific (App. A, p. 33a), the opinion otherwise holds that expense items contained in an individual cost-of-service including dry-hole expense are not a measure of a confiscatory rate (App. A, p. 32a). Since dry-hole expense is necessarily a major outlay of any producer that takes upon itself the finding of new reserves, the failure to recognize this item severely restricts the producer's opportunity to recover its operating expenses.

REASONS FOR GRANTING THE WRIT

(1) These proceedings involve an important question of Federal law which has not been, but should be, settled by this Court. Fundamentally that question is whether the basic constitutional and statutory standards for fixing rates for individuals pursuant to the Natural Gas Act may be ignored, as the Commission did in Opinion No. 468, or rendered ineffectual by complete and unquestioning reliance on the Commission's expertise, as the court of appeals did in its determination.

The Natural Gas Act is a major Federal regulatory statute designed for individual regulation of natural gas companies[2] and until now applied on that basis both to pipe lines and producers. By the action of the Federal Power Commission here under review the statute would be transformed to authorize a mass system of price control to be applied to large groups of companies. If such transformation is proper, it can be so only if the fixing of group rates can be reconciled with minimal constitutional and statutory criteria. These criteria provide that the individual must be afforded the opportunity to recover its operating ex-

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[2] *Bowles* v. *Willingham*, 321 U.S. 503, 517 (1944).

penses and capital charges.[3] This Court has approved a method for reconciling a group approach to a statute providing for individual regulation by requiring that the evidence used must be typical and representative of the group and that the individuals in the group should be afforded the opportunity to rebut any contention of typicality and representativeness and to except themselves from the group order on proper individual showing.[4] The Commission gave no recognition to these limitations and criteria.

Although the court below accepts the applicability of the typical and representative criteria as to both basic data and averages and further accepts the need that individuals be afforded the opportunity to make a presentation, nevertheless, the court's further holdings in effect vitiate these fundamental principles. With respect to representativeness and typicality, the court of appeals' total acceptance of the Commission's expertise ignores the absence of findings on these matters and the substance of this Honorable Court's clear holdings that weighted averages are suspect for such a determination.[5] Moreover, the complete acceptance of the Commission's expertise is simply a further aspect of the court's refusal to review procedural due process questions on the ground that it would be drawn into a turmoil of numbers and was considering only "errors of law."

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[3] *Federal Power Commission* v. *Natural Gas Pipeline Company of America*, 315 U.S. 575, 607 (1942); *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944); *Colorado Interstate Gas Company* v. *Federal Power Commission*, 324 U.S. 581, 605 (1945).

[4] *Akron, C. & Y. R. Co.* v. *United States (New England Divisions Case)*, 261 U.S. 184, 196-199 (1923).

[5] *United States* v. *Abilene and Southern R. Co. (The Orient Case)*, 265 U.S. 274 (1924); *Northern Pacific R. Co.* v. *Department of Public Works*, 268 U.S. 39 (1925); *Interstate Commerce Commission* v. *Mechling*, 330 U.S. 567 (1947).

The criterion for group rate making providing that the individual should be afforded the opportunity to make an individual presentation is also rendered of little effect by other of the court's holdings. Thus, the court's advisory statement that a company's failure to recover its expenses, including dry-hole expenses, is not a measure of what constitutes confiscation would deny to the producer the right to recover a major portion of expenditures that are indispensible in providing a gas supply. In addition, from the standpoint of the instant petition, this holding gives rise to a most fundamental constitutional question of what is confiscation.

The importance of the above issues is illustrated by the fact that there is being determined the pattern by which rates for the sales in interstate commerce of the vast natural gas producing industry will be hereinafter fixed. The determination herein is not, however, limited to natural gas producers or even to the Federal Power Commission. There is being additionally tested the latitude afforded any regulatory agency in adopting a group rate approach under the Constitution and under a statute providing for fixing rates of the individuals regulated. Indeed, this Court's expression of the power of a regulatory agency to fix group rates, its limitations in doing so, and the type of evidence on which it may rely, could well determine the future course of every Federal and state regulatory agency and every regulated industry. The fact that these issues have not been previously resolved by this Court is well illustrated by the reservation to this effect in both the majority and the dissenting opinions of the *Second Phillips* case, as previously noted (*supra*, p. 5), and as found by the Tenth Circuit (App. A, p. 14a).

(2) Another important reason for the grant of this petition is that the decision of the court below has, in the words of Rule 19 of this Court, "so far departed from the usual

course of judicial proceedings, * * *, as to call for an exercise of this court's power of supervision."

The action of the court of appeals in declining to review important procedural due process issues because of their claimed complexity in effect constitutes an affirmance of the Commission by default. It would thus appear that for a regulatory agency to avoid reversal, its action need not be legally supportable—only complex.

Petitioner recognizes the tremendous task facing any court reviewing a case of this magnitude, and the tendency of a litigant to attempt to draw the reviewing court into a *de novo* determination of all points in which it has been unsuccessful below. Accordingly, this Petitioner made every effort to limit its presentation to what it considered clear errors of law within easy comprehension of any court, eschewing argument on the Commission's many errors of law and fact which could be termed "substantial evidence questions." Nevertheless, the court below has lumped together all arguments directed at the propriety of the Commission's cost determination as too complex for its consideration.

The court of appeals' erroneous holding that it is confining its consideration to "errors of law" while declining to take up objections which it admitted to run "from hearsay evidence through deprivation of right of cross-examination to denial of procedural due process" (App. A, p. 23a) amounts to an immensely constricted view of what are "errors of law." If followed in other proceedings the discretion of regulatory agencies would be sharply expanded and the function of courts of review would be correspondingly contracted. Petitioner submits that this restriction of the scope of court review should not be permitted without the fullest consideration by this Court.

(3) Another aspect of the court of appeals' determination which requires review by this Court is its conflict with applicable decisions of this Court.

This Court has on numerous occasions reviewed just such issues as the court of appeals refused to consider, including the use of raw report data without affording the opportunity to cross-examine and rebut such data, *Northern Pacific R. Co.* v. *Department of Public Works*, 268 U.S. 39 (1925); *United States* v. *Abilene and Southern R. Co.*, 265 U.S. 274, 287-289 (1924); *West Ohio Gas Company* v. *Public Utilities Commission of Ohio*, 294 U.S. 63, 70 (1935), the use of weighted averages without findings of typicality and representativeness, *United States* v. *Abilene and Southern R. Co.*, 265 U.S. 274 (1924); *Northern Pacific R. Co.* v. *Department of Public Works, supra; Interstate Commerce Commission* v. *Mechling*, 330 U.S. 567, 583 (1947), and the general question of procedural due process as applied to administrative hearings, *Morgan* v. *United States*, 304 U.S. 1, 18-19 (1938). In addition the need for a tribunal below to clearly articulate the reasons for its determinations has been many times noted by this Court, *Virginian R. Co.* v. *United States*, 272 U.S. 658, 674-5 (1926); *Lawrence* v. *St. Louis-San Francisco R. Co.*, 274 U.S. 588, 596 (1927); *Cleveland C. C. & St. L. R. Co.* v. *United States*, 275 U.S. 404, 414-415 (1928); *Beaumont, S. L. & W. R. Co.* v. *United States*, 282 U.S. 74, 86-87 (1930), and actions which were not thus supported have been summarily reversed because the Supreme Court is not called upon unaided by opinion and finding to search a voluminous record, *Public Service Commission of Wisconsin* v. *Wisconsin Telephone Co.*, 289 U.S. 67, 70-71 (1933); see also *B. & O. R. Co.* v. *United States*, 279 U.S. 781 (1929).

A reviewing court cannot accept as expertise the determination of a regulatory body made without findings and analysis, *Burlington Truck Lines* v. *United States*, 371 U.S. 156, 167 (1962), and cannot interject its own discretion or that of the agency's appellate counsel as a substitute for the findings and analysis that the agency should have made, *Burlington Truck Lines* v. *United States, supra*, at 169; *N.L.R.B.* v. *Metropolitan Life Insurance Co.*, 380 U.S. 438,

443-444 (1965). Yet the Commission failed to make either adequate findings or analysis respecting the vital question of whether the basic data and averages are representative and typical, and the court of appeals rationalized the absence of such findings and analysis by blindly accepting the Commission's action as a product of its expertise. It is submitted that this was in direct conflict with the cases cited above.

CONCLUSION

For the foregoing reasons, this petition for writ of certiorari should be granted.

Respectfully submitted,

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April 18, 1967

APPENDIX

APPENDIX A

UNITED STATES COURT OF APPEALS
TENTH CIRCUIT

Nos. 8385, 8409, 8440, 8455, 8458, 8460, 8479, 8482, 8487, 8488, 8489, 8490, 8493, 8494, 8495, 8496, 8497, 8501, 8505, 8510, 8511, 8517, 8519, 8521, 8528, 8529, 8534, 8540, 8541, 8542, 8588 and 8589

JANUARY TERM, 1967

FILED

United States Court of Appeals
Tenth Circuit

Jan. 20, 1967

SKELLY OIL COMPANY; PHILLIPS PETROLEUM COMPANY; WARREN PETROLEUM CORPORATION; MOBIL OIL CORPORATION (formerly Socony Mobil Oil Company, Inc.); PAN AMERICAN PETROLEUM CORPORATION; NOTHERN NATURAL GAS PRODUCING COMPANY; STANDARD OIL COMPANY OF TEXAS, a Division of Chevron Oil Company; TEXACO INC.; HUNT OIL COMPANY jointly with H. L. Hunt, Lamar Hunt, N. B. Hunt, W. H. Hunt, Secure Trusts, Caroline and Loyd B. Sands, Caroline Hunt Trust Estate, Lyda Hunt-Caroline Trusts, Lyda Hunt-Bunker Trusts, Lyda Hunt-Lamar Trusts, Lyda Hunt-Herbert Trusts, Lyda Hunt-Margaret Trusts (formerly Estate of Lyda Bunker Hunt, Deceased), Hunt Industries (formerly Estate of Lyda Bunker Hunt, Deceased), and Placid Oil Company; HUMBLE OIL & REFINING COMPANY; SHELL OIL COMPANY; THE ATLANTIC RICHFIELD COMPANY (formerly The Atlantic Refining Company) jointly with Dorchester Gas Producing Company, Southland Royalty Company, and Westates Petroleum Company; CONTINENTAL OIL COM-

PANY jointly with Sunray DX Oil Company, Sinclair Oil & Gas Company, Cabot Corporation, Sohio Petroleum Company, Joseph E. Seagram & Sons, Inc., Joseph E. Seagram & Sons d/b/a Texas Pacific Oil Company, Gulf Oil Corporation, Murphy Oil Corporation, The Nueces Company, Samedan Oil Corporation, Cities Service Oil Company (formerly Cities Service Petroleum Corporation), Cities Service Production Company (now merged with Cities Service Oil Company), Columbian Fuel Corporation, Amerada Petroleum Corporation, Union Oil Company of California and as successor to The Pure Oil Company, Tidewater Oil Company, Reef Corporation, and William A. & Edward R. Hudson, Joint Operators; MARATHON OIL COMPANY; SUN OIL COMPANY; INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA; THE BRITISH-AMERICAN OIL PRODUCING COMPANY; UNION TEXAS PETROLEUM, a Division of Allied Chemical Corporation; MIDHURST OIL CORPORATION; THE SUPERIOR OIL COMPANY; PERRY R. BASS jointly with Panther City Investment Co., Bass Bros. Enterprises, Inc., Perry R. Bass, Incorporated, and Richardson Oils, Inc.; COLUMBIAN CARBON COMPANY jointly with Coltexo Corporation; THE STATE OF TEXAS; BIG CHIEF DRILLING COMPANY jointly with King-Stevenson Oil Company, Inc., and Service Drilling Company; TEXAS INDEPENDENT PRODUCERS AND ROYALTY OWNERS ASSOCIATION jointly with West Central Texas Oil and Gas Association; STATE OF NEW MEXICO; GULF OIL CORPORATION; and J. C. BARNES, et al.,

Petitioners,

v.

FEDERAL POWER COMMISSION,

Respondent,

STATE OF CALIFORNIA jointly with Public Utilities Commission of the State of California; CITY OF LOS ANGELES; CITY OF SAN DIEGO; CITY AND COUNTY OF SAN FRANCISCO; PACIFIC GAS AND ELECTRIC COMPANY; PACIFIC LIGHTING SERVICE AND SUPPLY COMPANY (formerly Pacific Lighting

Gas Supply Company) jointly with Southern California Gas Company and Southern Counties Gas Company of California; and SAN DIEGO GAS AND ELECTRIC COMPANY, *Intervenors.*

On Petition To Review Orders of the Federal Power Commission

Before LEWIS, BREITENSTEIN and HILL, Circuit Judges.

BREITENSTEIN, Circuit Judge.

The first area rate decision of the Federal Power Commission is before us for review. It relates to prices for jurisdictional sales of natural gas produced in the Permian Basin, a famous petroleum area where oil and gas are found in hundreds of reservoirs and thousands of wells. The states of Texas and New Mexico, the nation's oil and gas industry, and several related associations attack the decision. The State of California, the cities of San Francisco, Los Angeles, and San Diego, various local distributors, and an organization of such distributors support it. The rejection of the individual company cost-of-service approach to the regulation of independent producers and the adoption of the area rate method raise many novel issues which have been extensively and ably argued. We hold that neither the United States Constitution nor the Natural Gas Act bars the regulation of natural-gas prices on an area basis; that the Commission did not abuse its discretion in adopting the area method; and that the cases must be remanded because the actions of the Commission do not comply with the end result test established in Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 602-603, and other decisions.

The petitions for review, all brought under § 19(b) of the Natural Gas Act,[1] attack Opinions Nos. 468 and 468-A of the Commission fixing just and reasonable rates under §§ 4 and 5 of the Act for natural gas produced in the Permian Basin and sold to interstate pipeline companies.

1. *Background.*

The Permian Basin, as defined by the Commission, includes Texas Railroad Commission Districts Nos. 7-C, 8, and 8-A and the New Mexico counties of Chaves, Eddy, and Lea. Nationally, it accounts for about 11% of all the gas sold in interstate commerce. The Commission joined 336 producers as respondents in the consolidated proceedings. Sales by them are made to three interstate pipelines, none of which appear here.[2] About 85% of the Permian gas moving interstate goes to California.

Nearly two-thirds of the Permian gas production come from oil-well gas, that is, gas produced in conjunction with oil. Because of impurities much of the gas must be processed before introduction to an interstate pipeline. Until El Paso began its purchases, Permian oil-well gas was generally vented or flared because of the lack of a market.

The natural-gas industry has three main parts, the producers, the interstate pipelines, and the distributors. The last are under state or local regulation exclusively. The Commission began federal regulation of the interstate pipelines after the passage of the Natural Gas Act of 1938.

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[1] 15 U.S.C. §§ 717-717w.

[2] El Paso Natural Gas Company began buying Permian gas in 1945, Northern Natural Gas Company through a predecessor in 1954, and Transwestern Pipeline Company in 1958. In 1961, El Paso purchased 73% of the Permian gas moving in interstate commerce, Northern 18%, and Transwestern 9%.

It did not attempt to regulate independent producers[3] until the 1954 decision of the Supreme Court in Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672, (First Phillips) which held that the Act applied to them.

Section 7 of the Act forbids the sale of natural gas subject to Commission jurisdiction without a certificate of public convenience and necessity granted after notice and hearing. Temporary certificates, issued without notice and hearing, are authorized. Our recent decision in Sunray DX Oil Company v. Federal Power Commission, 10 Cir., —— F.2d ——, discusses § 7 procedures and problems. These are not present here because the § 7 applications considered in the consolidated proceedings before the Commission were disposed of in a separate order.

Section 4 requires that all rates shall be just, reasonable, and nondiscriminatory. No change shall be made in a rate without 30 days' notice. When a schedule containing a changed rate is filed, the Commission on its own initiative or on complaint may suspend the rate and set the matter for hearing. The suspension may be for not longer than five months. If no decision is reached within that period, the increased rate becomes effective but the Commission may require a bond conditioned upon the refund of that portion of the increased rate found not to be justified. The instant proceedings involve a number of increased rate filings which were suspended under § 4 and which were disposed of by Opinions Nos. 468 and 468-A.

Section 5 provides that whenever the Commission, after hearing had on its own motion or on complaint, finds that a rate is "unjust, unreasonable, unduly discriminatory, or preferential" it shall determine "the just and reasonable

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[3] The word "independent" is used to describe a producer which does not transmit gas interstate either by its own operations or those of an affiliate. Some of the interstate pipelines produce a share of their own gas and sell gas to other pipelines.

rate." In the proceedings at bar the Commission pursuant to § 5 established "the future rates for jurisdictional sales of gas by producers in the area."

After the First Phillips decision the Commission received thousands of certificate applications from producers. The situation was complicated by the need of pipelines for a committed source of supply sufficient to justify financing. To obtain such supply long-term contracts, commonly for 20 years, were made with the producers. They in turn, because they could not file unilaterally for an increased rate contrary to contract and because they desired protection against the unforeseeable economic conditions of the future, insisted on escalation clauses of various types.[4] A general price rise occurred. As the escalation provisions became operative the producers filed under § 4 for increased rates and the Commission suspended many of them. Section 7 applications were under contracts calling for rates comparable to those which the Commission had suspended. This trend was ended by the 1959 decision in Atlantic Refining Co. v. Public Service Commission of New York, 360 U.S. 378, (CATCO) which directed the Commission in certificate cases to keep initial prices in line.

After the remand in First Phillips, the Commission proceeded with the consideration of just and reasonable rates required by §§ 4 and 5 on the individual company cost-of-service basis which it had long applied in the regulation of electric power companies and interstate pipelines. The first case to reach the decisional stage was that relating to Phillips. On September 28, 1960, the Commission entered Opinion No. 338[5] in which it held that the regulation of independent producers under the Act could be accomplished more appropriately by the establishment of area rates

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[4] See Pan American Petroleum Corporation v. Federal Power Commission, 10 Cir., 352 F.2d 241, 243.

[5] 24 FPC 537.

than by the establishment of producer rates on individual cost-of-service findings. Contemporaneously with this Phillips decision, the Commission promulgated its Statement of General Policy No. 61-1[6] which established 23 rate areas and, with unimportant exceptions, announced maximum rates for each area. Two price standards were set, one for initial prices in new contracts and one for escalated prices in existing contracts. For the Permian Basin area the prices were 16 cents and 11 cents respectively.

Opinion No. 338 was affirmed by the Court of Appeals for the District of Columbia Circuit[7] and by the Supreme Court in Wisconsin v. Federal Power Commission, 373 U.S. 294, 310, (Second Phillips) wherein the Court observed that it shared "the Commission's hopes that the area approach may prove to be the ultimate solution" to the problem of regulating the independent producers.

The first area rate proceeding was that for the Permian Basin and was initiated on December 23, 1960.[8] It was followed by a similar proceeding for the South Louisiana area,[9] for the Hugoton-Anadarko area,[10] and for the Texas Gulf Coast area.[11] The last three are in the hearing stage. The Permian Basin proceeding was decided by Opinions Nos. 468 and 468-A to which we turn.

2. *The Decision of the Commission.*

The 131-page original opinion, No. 468, followed by the 23-page opinion denying rehearing, No. 468-A, need only

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[6] 24 FPC 818.

[7] Wisconsin v. Federal Power Commission, D.C. Cir., 303 F.2d 380.

[8] Docket No. AR61-1, 24 FPC 1121.

[9] Docket No. AR61-2, 25 FPC 942.

[10] Docket No. AR64-1, 30 FPC 1354.

[11] Docket No. AR64-2, 30 FPC 1354.

be summarized at this point. The Commission found the area rate principle free from constitutional and statutory objections and adopted it. Contract prices were rejected as a basis for regulation and the reserves to production ratio was declared to be an inappropriate regulatory standand. The Commission set up a two-price system. It differentiated between gas produced as the sole product of a well, referred to as gas-well gas, and gas produced in association with oil, known as oil-well gas or casinghead gas. One price was established for new gas-well gas and the residue therefrom sold under contracts made on or after January 1, 1961. A second price was established for flowing gas which was defined to include gas-well gas sold under contracts executed before the mentioned date, casinghead gas, and residue gas derived from either source. The January 1, 1961, date of division between new gas-well gas and old gas-well gas was adopted because that was the approximate date when the industry became able to direct its exploration efforts toward finding gas-well gas as distinguished from finding gas as a by-product in the search for oil. For new gas-well gas the Commission fixed a rate of 16.5 cents per Mcf for the Texas Railroad Districts inclusive of state and local taxes and a rate of 15.5 cents per Mcf for the New Mexico counties exclusive of applicable state and local production taxes. For flowing gas the respective rates were 14.5 cents and 13.5 cents.

In determining these rates the Commission gave consideration to composite costs but treated the two categories of new gas-well gas and flowing gas differently. It said that the price of the former "was geared to the cost of finding and producing future gas supplies and as such was built up primarily from nationally published statistics and the questionnaire data." For flowing gas it said "our touchstone is the historical cost of gas being produced in the Permian Basin area."

The Commission required adjustment on an individual company basis from the stated prices to reflect differentials

from the quality standards. These downward adjustments are determined "by the net cost of processing the gas to bring it up to standard." A downward adjustment is also required if the Btu content is less than 1,000 per Mcf and an upward adjustment is permitted if that content is above 1,050.

Small producers, defined as those making less than 10 million Mcf of jurisdictional sales annually, are exempt from the quality adjustments and from certain filing requirements.

The Commission set a minimum price of 9.0 cents per Mcf. Provision is made for special exemption from area rates. Refunds of excess collections are required on an individual company basis. The possibility of changes in area rates is recognized. A moratorium, until January 1, 1968, is declared on rate increases and indefinite escalation clauses are prohibited.

Three commissioners filed separate opinions. With one exception Commissioner O'Connor approved the results reached but said that "the contract price at which most producers are able and willing to operate is just and reasonable" and that "composite costs best serve as a check on average field prices to preclude significant price departures." He disapproved the Btu adjustment saying that an upward adjustment should be applied for all gas having a Btu content in excess of 1,000. Commissioner Ross was critical of accounting methods used and pointed out the need for simplification. He dissented from the division date between new and old gas-well gas. In his view the new gas-well gas price should apply to gas sold after the date of the Commission decision. Commissioner Black said that the allowed 12% rate of return on net investment "is very probably a generous one" but was justified by the special risk of finding substandard gas in the Permian Basin.

3. *Disqualification of Two Commissioners.*

The Continental Group of petitioners urges that Commissioner Black was disqualified to participate in the decision. The Independent Petroleum Association of America, (IPAA) complains of the participation of both Commissioners Swidler and Black. The claim is that each of them had prejudged the issue of whether substantial competition existed among producers. Additionally, Commissioner Black is accused of personal bias against the producers. The charges stem from public addresses made in 1964.[12] No claim is made that either commissioner prejudged the ultimate issue of a just and reasonable rate. In our opinion no basis for disqualification arises from the fact or assumption that a member of an administrative agency enters a proceeding with advance views on important economic matters in issue. Nothing in the record disturbs the assumption that the two commissioners are "men of conscience and intellectual discipline, capable of judging a particular controversy fairly on the basis of its own circumstances."[13] The cases cited by Continental and IPAA are not in point.[14]

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[12] A motion for the disqualification of Commissioner Black was made to and denied by the Commission. We find no similar motion in the record pertaining to Commissioner Swidler.

[13] United States v. Morgan, 313 U.S. 409, 421. See also Federal Trade Commission v. Cement Institute, 333 U.S. 683, 700-703.

[14] In Texaco, Inc., v. Federal Trade Commission, D.C. Cir., 336 F.2d 754, vacated 381 U.S. 739, the charge was precommitment of a commissioner on the guilt of an accused. In Gilligan, Will & Co. v. Securities and Exchange Commission, 2 Cir., 267 F.2d 461, certiorari denied 361 U.S. 896, a similar charge was made against a commission. Amos Treat & Co. v. Securities and Exchange Commission, D.C. Cir., 306 F.2d 260, related to a charge against a commissioner who had previously served as a staff member in the investigation which led to the complaint.

4. *Objections of Texas and New Mexico.*

The states of Texas and New Mexico, besides adopting the briefs and arguments of the Continental Group, assail the Commission decision on grounds peculiar to them in their governmental capacity. They say that the public interest, which the Commission is required to protect, includes the producing states as well as the consuming states; that the prices which the Commission has set will cause a cessation or curtailment of exploration and development activities to the serious injury of the economy of the Permian Basin; that waste rather than conservation of a natural resource will result; and that the states and their public entities will suffer severe losses in taxes and royalty payments.[15] Similar arguments were made by West Virginia in Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 607-614, and were rejected by the Supreme Court which said that when Congress passed the Natural Gas Act it "was quite aware of the interests of the producing states in their natural gas supplies" and that nothing in the Act intimates that high prices should be maintained so that "the producing states obtain indirect benefits." The rejection of the state's contentions in Hope requires the rejection of the same contentions here.

Texas and New Mexico also argue that the Commission has unlawfully interfered with their power of taxation. The Commission fixed the rates of gas produced in Texas to include all state taxes and in New Mexico to exclude such taxes. It said that: "In the event of any increase in taxes in Texas or New Mexico, the Commission will consider whether ceiling prices shall be increased and, if so, to what extent." The states' arguments are premature. The Commission has allowed all present taxes as a cost item. Nothing in the Commission decision inhibits the

[15] In Texas 4.7 million acres of public lands are within the Permian Basin and in New Mexico over 3 million acres. Much of this land is leased for oil and gas and produces royalty income.

states from increasing those taxes. The Commission has said that if they do, it will determine whether such increases should be passed on to the consumer or remain on the shoulders of the producers. The question of whether increased state taxes will unreasonably burden interstate commerce is hypothetical at this stage.

New Mexico complains that the establishment of a ceiling price plus existing taxes for gas produced in its portion of the Permian Basin denies to it the power to provide a tax incentive to producers by reducing the tax. The argument is not persuasive. If the New Mexico tax was reduced, the Commission could properly consider a rate decrease to reflect the tax decrease.

5. *Legality of Area Rates for Permian Basin.*

The problems confronting federal regulation of the natural-gas business, and particularly the independent producers, have been discussed several times [16] and need be only summarized. The interstate gas business is concerned with a wasting, nonreplenishable natural resource subject to production after discovery. At the point where the gas enters interstate commerce there are few buyers and thousands of sellers. The producers range from the financially powerful integrated oil companies to the wildcatters who operate on a shoestring. Their results are measured by the amount of gas produced—not by the amount of money invested. Exploration and development costs are financed out of current income and are charged to ex-

[16] See opinions of Justice Jackson dissenting in Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 628, and concurring in Colorado Interstate Gas Co. v. Federal Power Commission, 324 U.S. 581, 608; dissenting opinion of Justice Douglas in First Phillips, 347 U.S. 672, 687; dissenting opinions of Justice Clark in First Phillips, 347 U.S. 672, 690, and in Second Phillips, 373 U.S. 294, 315; dissenting opinion of Justice Harlan in Sunray Mid-Continent Oil Co. v. Federal Power Commission, 364 U.S. 137, 159; and Opinion No. 338 of the Commission, 24 FPC 537, 542-548.

pense rather than capital. The uncertainty of the business causes substantial cost and revenue fluctuations not only from producer to producer but also from year to year for the same producer. A regulated commodity, gas, is produced in substantial quantities along with an unregulated commodity, oil. The allocation of costs between them baffles the experts and presents the temptation to use mathematical means of arriving at a predetermined result. The same rate may bring a financial windfall to one producer and a financial disaster to another. The price of gas must be competitive with that of other sources of energy and must be sufficiently attractive to encourage a continued search for new supplies.

In Federal Power Commission v. Natural Gas Pipeline Co., 315 U.S. 575, 582, a case relating to pipeline rates, the Court held that the provisions of the Act were consistent with the due process clause of the Fifth Amendment and within the commerce power. Another pipeline case, Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 602, says that in fixing rates the Commission is "not bound by the use of any single formula or combination of formulae"; that "under the statutory standard of 'just and reasonable' it is the result reached not the method employed which is controlling"; and that the impact of the rate order rather than the theory behind it is the governing criterion. The "end result" test of Hope was followed in Colorado Interstate Gas Co. v. Federal Power Commission, 324 U.S. 581, 605-606.

Second Phillips, 373 U.S. 294, holds that the Commission did not abuse its discretion in terminating the § 5 investigation of Phillips' rates and substituting an area basis for an individual company basis. The Court reaffirmed the principles announced in Natural, Hope, and Colorado Interstate, recognized the difficulties inherent in the regulation of the price of natural gas, shared the Commission's hope for the success of the area approach, and observed

that the "case might be different if the area approach had little or no chance of being sustained."[17] At the same time, the Court pointed out that "the lawfulness of the area pricing method" was not before it for review.[18] Four justices dissented in an opinion which characterized the area rate policy of the Commission as "a new, untried, untested, inchoate program which, in addition, is of doubtful legality."[19]

In Callery[20] the Court mentioned that the § 7 proceedings before it had at one time been consolidated with the South Louisiana area rate proceedings. Contrary to the argument of the California Distributors the Court did not, tacitly or otherwise, approve area rate regulation. The most pertinent comment is that of Justice Harlan in his concurring and dissenting opinion who said that area pricing "ultimately aims to simplify proceedings under the statute."[20a]

We cannot accept the arguments of the Commission and the California groups that the Supreme Court has determined the validity of area pricing under the Act. We read the decisions to mean that the Court has permitted the Commission to go forward with the area rate experiment and wishes it good luck in the development of a workable procedure which will be free from constitutional and statutory pitfalls.

Governmental price regulation of services and commodities on a group or geographical basis has been up-

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[17] 373 U.S. 294, 310, 314.

[18] Id. at 308.

[19] Id. at 317.

[20] United Gas Improvement Co. v. Callery Properties, Inc., 382 U.S. 223, 225-226.

[20a] Id. at 231.

held in a number of decisions[21] under the federal commerce and war powers and under state police powers. Those supporting the Commission place great reliance on these decisions. The producers painstakingly distinguish each from the case at bar. We decline to be drawn into these tortuous sidepaths because we are convinced that the "translation of an implication drawn from the special aspects of one statute to a totally different statute is treacherous business."[22] Specific reference need be made to only one decision. Several producers emphasize the statement in Bowles v. Willingham, 321 U.S. 503, 517, that in the Natural Gas Act "Congress has provided for the fixing of rates which are just and reasonable in their application to particular persons or companies." The argument is that by this language the Supreme Court has recognized that regulation under the Act is on an individual company rather than group basis. We do not agree. The statement is dicta and whatever value it might have had as dicta was, in our opinion, destroyed by the blessing which the Court gave area rate making in Second Phillips.

Producers urge that the language of the Act is contrary to regulation on a group basis because all pertinent references to natural-gas companies are in the singular. First Phillips holds that an independent producer is a "natural-

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[21] See The New England Divisions Case, 261 U.S. 184 (ICC—divisions of joint rates); Aetna Insurance Co. v. Hyde, 275 U.S. 440 (Missouri regulation of fire insurance rates); Tagg Bros. v. United States, 280 U.S. 420 (Packers and Stockyards Act of 1921); Nebbia v. New York, 291 U.S. 502 (New York Milk Control Act); United States v. Rock Royal Co-op., 307 U.S. 533 (Agricultural Marketing Agreement Act of 1937); Sunshine Anthracite Coal Co. v. Adkins, 310 U.S. 381 (Bituminous Coal Conservation Act); Bowles v. Willingham, 321 U.S. 503 (Emergency Price Control Act of 1942); New York v. United States, 331 U.S. 284 (ICC—railroad rates); and Ayrshire Collieries Corp. v. United States, 335 U.S. 573 (ICC—railroad rates).

[22] Federal Trade Commission v. Bunte Bros., 312 U.S. 349, 353.

gas company" within the purview of the Act. Section 2, the definitions section, provides that "person" means an individual or corporation, and defines "natural-gas company" to mean a person engaged in transportation or sale of natural gas in interstate commerce. Section 4, covering the filing and changing of rates, refers to "any natural-gas company," "no natural-gas company," "every natural-gas company," and "the natural-gas company." Section 5, authorizing investigation and determination of rates, refers to "any rate," by "any natural-gas company" and to "such natural-gas company." Section 7 provides for certificates of public convenience and necessity and uses the terms "a natural-gas company," "no natural-gas company" and "such natural-gas company." The repeated use of the singular rather than the plural is said to require that the just and reasonable rate of each particular seller be tested with reference to its peculiar circumstances and operations.

Opposing arguments point out that the Act does not prohibit group or area rate making and that § 16 empowers the Commission to perform any and all acts and to prescribe such orders, rules, and regulations "as it may find necessary or appropriate to carry out the provisions of this act."

The basic query is whether the just and reasonable standard applies on an individual company basis or on a group basis. Section 4(a) says that "all rates * * * made * * * by any natural-gas company * * * shall be just and reasonable * * *." If this means that each producer is entitled to a rate which will return its costs plus a reasonable profit, the inquiry is at an end because the Commission refused to receive individual cost figures.

The Natural, Hope, Colorado Interstate, and Second Phillips decisions all support the conclusion that in the regulation of natural-gas rates the Commission is not bound by any formula or method, and that the choice of

the appropriate method for the determination of those rates lies in the sound discretion of the Commission. The appropriateness of the method depends on the peculiar characteristics of the natural-gas industry.

In its Opinion No. 338,[23] the Commission noted the reasons why the individual company cost-of-service method was inapplicable and unworkable. Among these were the lack of a fixed determinable relationship between investment and service to the public with the result that "a huge investment might yield only a trickle of gas, while a small investment might lead to a bonanza," the staggering allocation problems which could result in such anomalies as widely varying prices for gas coming from a jointly owned lease or even from a jointly owned well, and the intolerable administrative burden of requiring a separate rate determination for each of the several thousand independent producers.

The powerful contrary argument is that no area rate, whether based on composite costs, average aggregate costs or any other industry wide criteria, will suffice to assure a high cost producer of its costs to say nothing of a profit. We accept this as true.[24] The impact of an area rate in the natural-gas industry may have effects which cover the entire range from bonanza to bankruptcy. It is sufficient for us that these results were lucidly demonstrated

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[23] 24 FPC 537.

[24] An appendix to the Hunt brief presents an array of natural-gas costs of 44 Permian producers whose volumes total over 208 million Mcf. Of these, 16 producing over 170 million Mcf are shown to have costs of less than 14.5 cents. The remainder have costs running from 14.77 cents to 216.05 cents. We have been unable to check the accuracy of these figures and mention them only to show the claimed disparity of costs. Continental says that "approximately 67 percent of the companies and approximately 30 percent of the volumes had costs above the industry average cost level."

in the dissenting opinion of Justice Clark in Second Phillips and did not deter the majority from allowing the Commission to proceed with its area rate program.

Some of the producers argue that if the Act is construed to permit area rate making, the Act is invalid under Art. I, § 1, of the United States Constitution because no legislative standards have been set for establishing groups or making group determinations. Reliance is had on Panama Refining Co. v. Ryan, 293 U.S. 388, which held that a delegation of legislative power to the President was unconstitutional because Congress, among other things, "has declared no policy, has established no standard, has laid down no rule."[25]

Congress cannot delegate its power to enact laws but it can confer on an administrative agency the power to carry into effect laws which it has enacted.[26] In the New England Divisions Case, supra, the Court referred to the power given by Congress to the Interstate Commerce Commission to determine just and reasonable rates and said that Congress "intended that a method should be pursued by which the task * * * could be performed."[27] In Lichter v. United States, 334 U.S. 742, 785-786, the Court in discussing legislative standards said that the "standards prescribed by Congress are to be read in the light of the conditions to which they are applied" and for an example observed that "among those which have been held to state a sufficiently definite standard for administrative action [are] 'just and reasonable' rates for sales of natural gas."

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[25] 293 U.S. 388, 430.

[26] Crain v. First National Bank of Oregon, Portland, 9 Cir., 324 F.2d 532, 537.

[27] 261 U.S. 184, 197.

In the regulation of the natural-gas industry "the actual necessities of procedure and administration" [28] have led to the adoption of the area rate method. We believe that neither constitutional nor statutory provisions prevent the use of that method and that the Commission did not abuse its discretion in adopting it. The more important and difficult question is that of the validity of the area rates which have been established. The controlling standard is the end result test of Hope. In our opinion, this test is accepted by, and reaffirmed in, the Second Phillips decision.

Some of the producers urge that the area rate method is not consistent with the characteristics of the industry and that contract prices satisfy statutory requirements because they have been reached through effective competition. The Commission considered and rejected the argument. It pointed to the history of price negotiatons in the Permian Basin, to the urgent requirements of the pipelines, to the heavy percentage of sales by a few producers, and to the control of undisclosed and uncommitted gas reserves by a few producers. It concluded that the record fails to establish that a just and reasonable rate can be established through competition and that "the primary competition revealed by the record was among the pipelines to secure new gas supplies at higher prices." Commissioner O'Connor disagreed saying that "the contract price at which most producers are able and willing to operate is just and reasonable." His conclusion was that "profit oriented costs and supply oriented contracts do not, in the aggregate, depart in any significant manner from each other." We accept the conclusion of the Commission that competition has not been effective to fix a just and reasonable rate. It is supported by reasonable inferences from the record and they are binding on us.

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[28] Id. at 198.

Continental and Superior say that they were improperly denied an opportunity to be heard on the geographical propriety of the Permian Basin as a rate area. In its order instituting the proceedings the Commission eliminated the issue of the appropriateness of the area for rate making purposes.[29] The Commission may draw on its expertise to determine the ground rules for an investigation but in so doing may not deny a specific right.[30] The producers fail to convince us that any such denial has occurred here. The Permian Basin is a well known area. Unless prices are to be determined on a national basis, areas must be selected and defined. The Commission had two choices. It could first determine the national revenue requirement and divide that up among the areas or it could first determine the various rates so that in the aggregate they meet that requirement. We are unwilling to assume that when all the area proceedings are completed the total revenue will not equal the national requirement. If it does not, both the producers and the consumers will suffer. In our opinion the Commission acted reasonably in selecting the Permian Basin for an area rate proceeding.

6. *The Two-Price System.*

The Commission's two-price system is vigorously attacked on many fronts. It will be remembered that one price is fixed for new gas-well gas and another for flowing gas. All agree that gas is a commodity which is valuable as a source of energy. The householder does not care whether the gas which burns at the tip of his appliance comes from a gas well, an oil well, or as a residue product. To him gas is gas.

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[29] 24 FPC 1121, 1122.

[30] Amax Petroleum Corporation v. Federal Power Commission, 10 Cir., 350 F.2d 92, 94.

The justification for the two-price system is that the higher price for new gas-well gas provides an incentive to explore for and develop new supplies. The producers do not question the finding that "the industry is increasingly becoming able to direct its exploration efforts toward finding new gas-well gas as distinguished from finding gas as a by-product in the search for oil." This ability may be confined to the larger companies which maintain the technical staffs skilled in making the necessary predictions. The smaller producers are in a less advantageous position. They may be relegated to the farmouts which the majors pass down to them or to operations in accord with their less scientific but sometimes financially rewarding hunches.

New gas discoveries are well said to be the life blood of the industry. The consumers may reasonably be required to pay the price needed to bring forth such discoveries. If an incentive price based on current costs is used for all gas, windfalls will be assured to many producers of old gas developed under lower historical costs and often found in association with oil.

The producers say that a single-price system based on current costs is required because revenues for current exploration and development must be internally generated from sales of gas from whatever source. The Commission rejected the argument. The question is not so much the source of the funds as it is the inducement to use available funds in the search for gas. The higher price for new gas is intended to supply that inducement. Although the adequacy of the inducement can only be tested by future developments, we are not convinced that the refusal of the Commission to include the same inducement in the price of old gas, with the resulting likelihood of windfalls, was unreasonable.

Continental, Phillips, and others argue that the two-price system amounts to entrapment because of the possibility of

reduction in price after financial commitments have been made. Although the Commission which announced the Permian Basin decision cannot bind a future Commission, we credit the Commission with good faith. The possibility of a change does not invalidate the rate method employed. When and if a reduction occurs, the argument of entrapment can be heard.

The division date of January 1, 1961, for the different prices of new gas-well gas and old gas-well gas is another subject of dispute. Here the Commission found as a fact that the appropriate date was the approximate time when directional drilling came to be used effectively. Under the evidence the selection of a division date was an administrative problem calling for the exercise of judgment. In making its choice the Commission acted within the evidence and within its powers. On rehearing, the Commission left open for future consideration the problem arising when new gas-well gas is developed from committed acreage. We assume that this problem will be met fairly when it comes to a head.

The two-price system is an outgrowth of directional drilling for gas. Its purpose is to assure a continued gas supply. The Commission frankly says that the adoption of the system for the Permian Basin "should serve to furnish a practical test of whether in fact it will result in bringing forth additional supplies." We find no persuasive reason why the test should not be made.

7. The Cost Information.

In arriving at the Permian Basin rates the Commission used many sources of cost information. These included responses to questionnaires sent to producers, the Census of Mineral Industries for 1958, the Chase Manhattan Bank's 1961 Annual Analysis of the Petroleum Industry,

the World Oil Magazine, the Oil and Gas Journal, the Joint Association Survey,[31] and others. The producers attack these sources on many and varied grounds. The range of objections runs from hearsay evidence through deprivation of right of cross-examination to denial of procedural due process. To take up each of these objections would increase the length of this opinion to encyclopedic dimensions.

From the information so obtained the parties, the staff, and the Commission make many computations and reach many results. The assumptions, allocations, formulae, equations, averages, means, and massive calculations may intrigue a mathematician or statistician but they have no attraction for us. We respectfully decline to be drawn into such a turmoil of numbers. We cannot in a few months unravel the snarl of statistics developed in the years of hearings. In our opinion the judicial process, in cases such as this, should be confined to consideration of errors of law. We leave to the experts the selection of source material and the calculations to be made therefrom. Our concern is with the result.

8. *The Commission's Price Determinations.*

The Commission said that "costs must be a major factor in determining the area price." On the basis of current

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[31] This is a survey of a few producers conducted by the American Petroleum Institute, the IPAA, and the Mid-Continent Oil and Gas Association.

national statistics plus questionnaire data it determined the 1960 Mcf cost of new gas-well gas thus:

Exploration and Development Costs	
Dry Holes	1.42 cents
Other Exploratory Costs	1.59
Adjustment for Exploration in Excess of Production	1.11
Production Operating Expense	2.70
Net Liquid Credit	(3.10)
Regulatory Expense	.14
Depletion, Depreciation, and Amortization of Production Investment Costs	
Successful Well Costs	2.88
Lease Acquistion Costs	.76
Cost of Other Production Facilities	.31
Return of Production Investment (at 12%)	5.21[82]
Return on Working Capital	.35
Subtotal	13.37
Royalty at 12½ percent	2.05
Production Taxes	1.01
Total	16.43

The Commission rounded this figure off at 16.5 cents for the Texas production. Because the New Mexico figure is exclusive of taxes a reduction of one cent was made in the New Mexico price.

[82] This is computed as follows: The production investment is the sum of successful well costs, lease acquisition costs, and cost of other production facilities or a total of 3.95 cents. It is to be recouped over an average period of 10 years beginning an average of one year after investment. Accordingly, the return is allowed on an investment base 11 times the production investment of 3.95 cents per Mcf or 43.45 cents. 12% of this figure is 5.21 cents per Mcf.

For the costing of flowing gas the Commission used historical data developed by the industry questionnaires. The results may be summarized thus:

Production operating expenses	1.75 cents
Depreciation, depletion and amortization	2.42
Return at 12%	4.99
Exploration and development	4.08
Regulatory expense	.14
	13.38
State production tax at 7%	1.01
	14.39[33]

This figure was rounded off at 14.5 cents for Texas and 13.5 cents for New Mexico. As a check on the method used the Commission back-trended the new gas-well gas figures and arrived at a 14.64-cent price.

The rates so established are subject to downward adjustment because of quality deficiencies and to both downward and upward adjustments on the basis of Btu content. The Commission disclaims any intent that the rate figures show producer costs. It says that the price of new gas-well gas is "geared" to costs derived from national statistics and the questionnaire data and that for flowing gas the "touchstone" is the historical price of Permian gas.[34] Other undefined and unidentified "factors" were taken into consideration.

9. *The Moratorium.*

The Commission implemented the price provisions of the decision in various ways. It imposed a moratorium on rate increases until January 1, 1968, "except in compli-

[33] No separate item was included for royalty payments because costs were computed on 7/8 of actual volumes.

[34] In Opinion No. 468 the Commission said: "Nevertheless, we make clear that we do not confine ourselves to a cost calculation in determining just and reasonable rates."

ance with a specific order of the Commission for a rate as determined pursuant to said proceeding [AR61-1] or pursuant to later order of the Commission." The producers say this violates the Act because § 4 permits filings for rate increases. Section 4 must be read with other sections of the Act. Section 5 authorizes the Commission to determine the just and reasonable rate "to be thereafter observed and in force." Section 16 gives the Commission power to make such orders "as it may find necessary or appropriate to carry out the provisions of this act." In Callery the Court held that there was ample power under § 7(e) to impose a moratorium.[35] We believe that there is also ample power under §§ 5(a) and 16. The reasonableness of the exercise of the power is established by the need for price stability, the Commission's expressed willingness to reopen the proceedings to consider the propriety of changes, and the expiration date which is only about a year off.

10. *Escalation Clauses.*

The Commission's order forbids the filing of rate changes in excess of applicable area rates when the contractual right thereto is based on indefinite escalation clauses not permitted by § 154.93(a), (b), and (c) of the Regulations under the Natural Gas Act. The producers say that this provision destroys existing contract rights. The Commission replies that it has not proscribed the clauses but merely the right to file under them. This is a thin distinction. In Pan American Petroleum Corporation v. Federal Power Commission, 10 Cir., 352 F. 2d 241, 245, we upheld § 154.93 and pointed out that if a producer felt aggrieved thereby it could apply for a rule waiver under § 1.7(b) of the Commission's Rules of Practice and Procedure. We assume that a similar request could be made under the Permian order. When the request is made and rejected, the time will arrive for the consideration of the constitutional questions which the producers raise.

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[35] 382 U.S. 223, 228.

11. *The Commission's Fair Relationship Standard.*

In fixing the amounts of the area rates the Commission rejected the end result test and adopted a fair relationship standard. This appears clearly from Opinion No. 468-A. After disclaiming that it had made any finding that "jurisdictional revenues will equate to jurisdictional costs," the Commission said:

> "* * * we are convinced that the record fully justifies the Commission's judgment that the ceiling prices we have fixed 'provide a fair relationship between the aggregate price the consumer pays and the aggregate costs that the producers incur' in the Permian Basin."

Hope says that in the fixing of just and reasonable rates there must be a "balancing of the investor and the consumer interests."[36] It goes on to say that from the company point of view the revenue must not only provide operation expense but also capital costs including "service on the debt and dividends on the stock"; and that the return to the equity owner must be commensurate "with returns on investments in other enterprises having corresponding risks" and "sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital."[37] The Court concluded the discussion of this problem with the observation that in Hope the "end result" could not be condemned as unjust and unreasonable.

In Colorado Interstate Gas Co. v. Federal Power Commission, 324 U.S. 581, 605, the Court, after referring to the Natural and Hope decisions said:

> "In those cases we held that the question for the courts when a rate order is challenged is whether the order viewed in its entirety and measured by its end results meets the requirements of the Act."

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[36] 320 U.S. 591, 603.

[37] Ibid.

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Also pertinent is the statement of the Court in Second Phillips that:[38]

> "To whatever extent the matter of costs may be a requisite element in rate regulation, we have no indication that the area method will fall short of statutory or constitutional standards. The Commission has stated in its opinion in this proceeding that the goal is to have rates based on the 'reasonable financial requirements of the industry' in each production area, * * * and we were advised at oral argument that composite cost-of-service data will be considered in the area rate proceedings."

Nothing in Second Phillips rejects the end result test of Hope. We believe that it applies here and that it is not satisfied by a finding of fair relationship. Something more than mere semantics is involved. The determination of a fair rate from the standpoint of the consumers must depend to large extent on the informed judgment of the regulatory agency. In these proceedings no distributor, consumer interest, or consumer representative objects to the rates. They are accepted as just and reasonable.

From the standpoint of the producer the situation is different. It is entitled to recover its prudent operating expenses and capital costs with a return commensurate to the risk and sufficient to attract capital. These requirements must be tested against the record. They may not be brushed aside with a general finding of fair relationship. The Commission concedes that it did not equate jurisdictional costs to jurisdictional revenues. This is obvious because no determination was made of the jurisdictional revenues which the rates will produce.

12. *The High Cost Operator and the Small Producer.*

The Commission broke down the rates into components which it justified on averages based on national statistics

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[38] 373 U.S. 294, 309-310.

and questionnaire data. We recognize that weighted averages and sifted averages are suspect.[39] We accept the principle that both the basic figures and the averages obtained therefrom must be typical and representative but we are not convinced that the Commission has misused its expertise in this technical field. It is self-evident that when average costs are used to compute ceiling prices, the high cost operator will be hurt and some low cost operators may receive windfalls. Probably to a greater extent than in any other comparable segment of the national economy the element of chance can affect the success or failure of even the most prudent entrepreneur who engages in the natural-gas business.

The problem of the high cost operator is characteristic of group or area rate making. The Supreme Court upheld group rates in Acker v. United States, 298 U.S. 426, 431, and commented that "regulation cannot be frustrated by a requirement that the rate be made to compensate extravagant or unnecessary costs." In Tagg Brothers v. United States, D.C. Neb. 29 F. 2d 750, 755, affirmed 280 U.S. 420, the court said that it was not necessary "to fix the rates so high that all agencies in the business would make money." Covington & Lexington Turnpike Road Company v. Sanford, 164 U.S. 578, 596, says that "the public cannot properly be subjected to unreasonable rates in order simply that stockholders may earn dividends."

The small producers, represented here by Big Chief Drilling Company, IPAA, Texas Independent Producers & Royalty Owners Association (TIPRO), J. C. Barnes, and others, join in the prediction that the Permian decision sounds the death knell of the small producers. Perhaps the flamboyant wildcatter must be replaced by the scientists of the industrial giants but the efforts of the

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[39] See United States v. Abilene & Southern Railway Company, 265 U.S. 274, 291, and Interstate Commerce Commission v. Mechling, 330 U.S. 567, 583.

boom-or-bust adventurers have contributed greatly to natural-gas discoveries. In its decision the Commission referred to the "smaller independent who traditionally drills much of the Permian exploratory acreage" and said that: "Consumers and the natural gas industry alike have a strong stake in the continuation of the exploration efforts of the thousands of small operators who contribute a large share of the discoveries of new sources of gas." [40]

The Commission took note of the suggestions that small producers should be exempt from regulation.[41] It found that outright exemption was neither necessary nor desirable but said that the small producers needed "special treatment." To this end it defined a small producer as "a natural gas company selling jurisdictionally less than 10,000,000 Mcf annually on a nation-wide basis." They were granted relief from various requirements of §§ 7 and 4 and were freed from rate adjustments because of quality differentials. In our opinion the classification is reasonable and within the Act.

The small producers do not seek complete exemption. Their attitude is that such relief would be illusory rather than real because the pipelines would not pay more for gas supplied by them than the price paid to the major companies. Their complaint is that the Commission did not give adequate consideration to small producers' costs.

Data covering the costs of Permian producers came from questionnaires which are classified as Appendix B and Appendix C. The Appendix B group was mandatory for

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[40] Big Chief asserts that the small producers, although credited with only 20% of current production volumes, actually drill almost 40% of all successful gas wells and 50% of all successful exploratory gas wells.

[41] See statements of Justice Clark dissenting in Second Phillips, 373 U.S. 294, 329-330, and speaking for the Court in Federal Power Commission v. Hunt, 376 U.S. 515, 527.

producers with company-wide jurisdictional sales of over 10 million Mcf and optional for others.[42] The Appendix C questionnaires went to the small producers. Forty-two of the majors and 25 of the small producers answered Appendix B. The response to the Appendix C questionnaires was sporadic. The Commission used only the material supplied by the majors saying that the inclusion of the data supplied by the small producers "does not affect the results."

TIPRO and Big Chief both emphasize the testimony of a staff witness that the small producer questionnaire showed average unit costs 2 cents per Mcf higher than those of the majors. They argue that the end result standards must be applied not only to the entire group but to them as a group. The weakness of the argument is that once the whole group is split the process can be carried on until the regulation is back on an individual company basis.

We do not know the answer to the small producer problem. Superficially it seems unfair to fix ceiling prices for all producers, both large and small, on the basis of the costs of large producers only. The Commission rejected the small producer data because in its opinion the impact on the rate structure was de minimis. On the record presented, we are unwilling to say that this conclusion was erroneous as a matter of law.

In any regulation of the natural-gas industry on an area basis the high cost producers, be they majors or little fellows, are certain to be placed in a position less advantageous than that occupied by those whose good fortune and able management have supplied a lower cost base. We agree with the Commission that the expense items included in an individual cost-of-service are not the

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[42] Appendix A pertained to well and drilling statistics. It is not pertinent here.

measure of a confiscatory rate. A producer has no constitutional right to be reimbursed for dry-hole expenses.[43] Also it has no obligation to remain in business by replenishing the supplies of gas which form the basis of present obligations. Inability to continue exploration and development is not confiscation. We conclude that the impact of the Permian rates on the high cost producers does not destroy the area rate method.

13. *Gathering and Processing Costs.*

One subject of much discussion in the briefs is the allowance of the same rate for gas delivered at the tailgate of a processing plant and for gas delivered at the wellhead. Gathering lines cost money and have to be built and operated by someone. The Commission's position is that the revenues received for oil and oil products derived from condensation and processing return a profit which induces the building of the needed gathering lines and plants. Here again we reach the troublesome field of cost allocations between a regulated commodity, gas, and unregulated commodities, oil and liquified petroleum products.

Bass places particular emphasis on this phase of the case. It points to its extensive investments in gathering lines and plants and to its permanently certificated rate of 18 cents which, it says, the Commission has never specifically found unreasonable or discriminatory. The answer as we see it is that if area rates are proper no greater need exists for the consideration of the individual cost and revenue requirements in the case of Bass than in the case of the other producers. Perhaps in the future courts will have to explore the mysteries of allocations but we are not so inclined in this case. If in fact Bass and others similarly situated are confronted with confiscation, a way must be open for them to be heard.

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[43] Cf. Columbus Gas & Fuel Co. v. Public Utilities Commission of Ohio, 292 U.S. 398, 407.

14. *Special Exemptions.*

The Commission recognized that some provision must be made for special exemption from area rates. It said that when a producer's "out-of-pocket expenses in connection with the operation of a particular well are greater than the revenues under the applicable area price, he should be entitled to appropriate relief." It declined to "specify all of the special circumstances which may serve as a basis for exceptions to the area rate" and observed that failure to earn exploration and development expenses plus the allowed return does not amount to confiscation. In regard to the form of relief it held that "it may be sufficient to permit them to abandon their unprofitable sales."

We agree with the Commission that an escape clause cannot be used to convert an area rate into an individual company cost-of-service rate but an escape clause which does no more than prevent an unconstitutional confiscation amounts to nothing. None is needed for that purpose. The producers are right in saying that the Commission's exemption provisions are so vague and nebulous that neither they nor a court can determine what relief is being granted. Out-of-pocket expenses are not defined and we do not know what they include. If a producer's accounting is on a lease rather than well basis, the facts relating to a particular well might not be determinable. It may be going too far to say categorically that individual producers should be permitted to show that the group costs are not typical or representative of their costs but in some instances that should be permitted. Conservation of gas is promoted if marginal wells are allowed to continue to produce but is discouraged if the same wells are shut down by a low price. Some producers furnish gathering facilities. Others sell at the wellhead and the pipelines pay for the gathering. Gathering costs are allowed pipelines. Perhaps in some instances they should be allowed to producers. An adequate savings

clause should contain guidelines which if followed by an aggrieved producer will permit it to be heard promptly and to have a stay of the general rate order until its claim for exemption is decided. It is not enough to say in effect that confiscation will be prevented. Confiscation is an individual proposition and the individual is entitled to be heard. We are convinced that the Commission's special exemption provisions are inadequate.

15. *Quality Standards.*

The Commission provided for adjustments in the area rates to reflect quality differentials. It said that "the price of gas cannot be related to volume alone but must be related to units of energy free of impurities and sufficiently compressed to enter the pipeline." Standards were fixed for content of carbon dioxide, hydrogen sulphide, total sulphur, water, and other impurities; and the amount of delivery pressure was established. The applicable base area rate is adjusted downward by the net cost of processing the gas to bring it up to standard. Provision is made for both an upward and a downward adjustment of rate depending on the Btu content. Quality statements are required to be filed together with an agreement by the seller and the buyer covering the cost of bringing the gas up to standard. If an agreement cannot be reached, each shall file a statement of its views on the processing costs.

About 90% of the flowing gas is substandard. We are cited to no figures on the similar percentage of new gas-well gas. The amount of the rate adjustments does not appear in the record because there was no evidence of the extent of quality differentials or of the processing costs of bringing the gas up to standard.[44] At oral argument various estimates were given as to the amount of

[44] The Commission says in its brief that "appropriate price differentials or adjustments could not be made on the basis of the record."

rate reduction which would result from substandard quality. These were based on statements filed pursuant to the decision but after the record was closed. They ranged from .7 cents to 2.0 cents per Mcf. A spokesman for the Continental Group said that on 1960 volumes a revenue deficiency of some $12 million a year would result. The Commission response in this court to the Skelly motion for stay of the Commission's orders herein said that the reductions in applicable rates because of adjustments for quality standards are expected to result in a revenue reduction of about $10 million annually.[45]

The producers' argument that the imposition of quality standards violates procedural due process because of lack of notice need not be resolved at this time. We are remanding the case and now everyone has notice. The matter of the Btu adjustments presents a particular problem which was emphasized by Commissioner O'Connor in his dissent that the price goes down if the Btu content is below 1,000 and goes up if it is above 1,050. The producers say the adjustment upward should begin at 1,000. We do not understand the Commission's reasons for the gap. On remand this can be clarified.

16. *The Rate of Return.*

The Commission says that the impact of the quality adjustments is taken care of in the rate of return which is made generous on this account. It fixed a rate of return of 12% on production activities and held that such rate "protects gas consumers against excessive prices but it is not so low that it fails to respond to the needs of the

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[45] The statement was this: "It has been estimated that the reductions to the base rates alone will reduce the revenues from jurisdictional Permian sales by about $10 million annually. The adjustments for quality standards, which were substantially altered by Opinion 468-A * * * are expected to result in a further reduction of the same magnitude."

industry." The principles applicable to the determination of an appropriate return are set forth in Bluefield Water Works & Improvement Co. v. Public Service Commission, 262 U.S. 679, 692-693. It "must be determined by the exercise of a fair and enlightened judgment, having regard to all relevant facts." The rates of a public utility should "permit it to earn a return on the value of the property * * * equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties" but the utility has no constutional right to profits realized by "highly profitable enterprises or speculative ventures." The return should assure "confidence in the financial soundness of the utility" and be adequate under prudent management "to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties." The Hope decision[46] states the same basic principles.

The Commission recognized these controlling principles. The objections of the producers are to the point that the allowed rate of return is inadequate to enable the industry to attain the goals which the principles contemplate. At this time there is no need for us to go into the comparisons of the returns appropriate for producers as opposed to pipelines or to the financing methods employed by either. The fact is that by treating quality deductions as a risk rather than a cost the Commission has made it impossible to determine the amount of return with any degree of certainty. The difficulty is that the record does not disclose the amount of deductions.

A fair rate of return cannot be ascertained with mathematical certainty.[47] Pragmatic adjustments may be made

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[46] 320 U.S. 591, 603.

[47] Colorado Interstate Gas Co. v. Federal Power Commission, 10 Cir., 142 F.2d 943, 961\962, affirmed 324 U.S. 581.

by an agency within the ambit of its statutory authority.[48] A court must put great reliance on agency expertise in evaluating a rate of return but this does not mean that a court must accept the agency determination in blind faith. A producer is entitled to a higher rate of return than a pipeline because of the greater risk of the business. The Commission has here compounded the risk of discovery with the risk of substandard quality.

We believe that the price reductions to reflect quality deviations are an item of cost rather than an item of risk and should be directly reflected in the applicable base rates instead of hidden in a rate of return allowance. The amount of cost is the expense of bringing the quality up to standard. In the Permian Basin sound reason exists for this conclusion because of the known and substantial quality deficiencies particularly in flowing gas production. We find it hard to understand why a revenue deficiency in the estimated amount of $10 million annually should be classified as a risk and not a cost. A risk occurs as the result of unknown or unconsidered contingencies. In the Permian Basin it is known and considered that flowing gas falls short of pipeline standards. In any event, the lack of evidence as to quality deductions makes it impossible to determine whether the rate of return satisfies the Bluefield and Hope principles and we have no basis on which to appraise the allowance made by the Commission. We respect the expertise of the Commission but the conclusions reached by the use of expertise must accord with legal standards.

17. *Contract Limitations.*

The producers say that recovery of industry costs under the area rates is impossible because many of the existing contracts do not permit a producer to file for the flowing

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[48] Federal Power Commission v. Natural Gas Pipeline Co., 315 U.S. 575, 586.

gas ceiling price of 14.5 cents. The Commission recognized that "there undoubtedly will be some contract prices lower than the area rate ceiling, as adjusted for quality." Some of the producers estimate the deficiency because of contract limitations to be $14.4 million in the test year of 1960. The Commission has estimated that a reduction of base rates alone will result in a revenue reduction of about $10 million annually.[49]

It is elementary that gas prices are originally set by contract between the producer and the pipeline, that the producer may not raise the price unilaterally, and that any increase in price must be within contract terms unless the price is set so low as to affect the public interest. The Commission says that the producers are not entitled as a matter of right to collect contract rates that are higher than otherwise reasonable in order to offset other rates limited by contract to below maximum reasonable levels. Regulation does not guarantee an over-all profit;[50] relief from an unduly low rate may be given only if the rate is "so low as to adversely affect the public interest—as where it might impair the financial ability of the public utility to continue its service, cast upon other consumers an excessive burden, or be unduly discriminatory";[51] and a company's losses in one instance do not justify an illegal gain in another instance.[52] At the same time in such group procedures as the division of railroad rates the Interstate Commerce Commission, with court approval, has recog-

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[49] See supra, note 45.

[50] Federal Power Commission v. Natural Gas Pipeline Co., 315 U.S. 575, 590.

[51] Federal Power Commission v. Sierra Pacific Power Co., 350 U.S. 348, 355.

[52] Federal Power Commission v. Tennessee Gas Transmission Co., 371 U.S. 145, 153.

nized that revenue from one source may balance that from another.[53]

Contract limitations are one of the facts of life for the natural-gas industry. They are the outgrowth of the days when gas, which had previously been vented, flared, or capped, became salable to the newly constructed interstate pipelines. The pipelines wanted long-term contracts and the producers wanted to sell their gas. Prices were low. With the phenomenal increase in the use of gas as an energy source the prices rose. The producers whose contracts either contained no escalation clauses or clauses of the type proscribed by the Commission were in a disadvantageous position. Even permissible escalations do not, in many instances, bring the 1960 price up to the area ceiling. In Second Phillips the Court upheld the termination of certain § 4(e) dockets on the Commission's finding that "the annual increase in revenue produced by these increased rates was substantially less than the deficit for the test year 1954."[54] The same situation exists here for many companies. We do not know whether it exists for the area producers as a group because no finding was made of revenue and requirements. The Supreme Court has said that losses in one instance do not justify illegal gains in another. To us this means that the contract limitations do not preclude the establishment of a just and reasonable area rate. The answer is provision for a minimum rate.

The Commission held that "the establishment of minimum rates in this case is in the public interest and that the price impact on the consumer will be de minimis." It established a minimum rate of 9 cents per Mcf for gas of standard pipeline quality. We believe that the controlling question is whether the proper revenue requirements of the area producers as a group can be satisfied with rates

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[53] See New England Divisions Case, 261 U.S. 184.

[54] 373 U.S. 294, 305.

having the ceiling and the floor which the Commission has fixed. This cannot be answered because the financial impact of the quality deductions is not ascertainable from the record.

18. *Refunds.*

The revenue deficiency argument of the producers leads directly to the refund issue. The Commission required "appropriate refunds in the case of rates which are the subject of proceedings under Section 4(e) of the Act, and have thus been collected subject to an obligation to refund amounts collected in excess of the just and reasonable rates as here determined." Procedures to accomplish this result were set up in detail.

The producers say that these individual company refunds are not proper because of the revenue deficiency of the industry. They say that in the test year of 1960 the producers in the area failed to meet their revenue requirements by $14.4 million and they estimate the refunds for that year under the Commission decision to approximate $6 million.

The Examiner held that refunds should be ordered only to the extent that over-all industry revenues exceed over-all industry expenditures in a given year. The Commission said that this theory was unworkable because it would result in inequities among both the buyers and the producers and because of "insurmountable" administrative difficulties. We are at a loss to understand how refund obligations, which might come into existence under the Examiner's approach, would be divided among the producers.

We see no escape from the requirement that refunds be on an individual company basis and on a schedule by schedule basis. As we understand Federal Power Commisison v. Tennessee Gas Transmission Co., 371 U.S. 145, 153, refunds are appropriate for each excessive rate

regardless of over-all revenues. The Commission has required refunds only on § 4(e) rate increases above the applicable area ceiling. If a producer claims that the refunds required of it are confiscatory or harmful to the public interest, it must have an opportunity to petition for special relief. A similar opportunity must be afforded if a producer can show that a refund is required for collections at or below the "last clean rate."[55] An adequate special exemption clause can take care of such situations.

19. *The End Result Test.*

This brings us back to the end result test. The Continental Group, which includes many large producers and major integrated oil companies and which is supported by Phillips, presents alternative arguments. The first is economic. It is said that regulation under the Act must be consistent with the economic characteristics of the industry; that this requires the establishment of market prices based on contracts; that a cost-based system of regulatory rates does not recognize the responsiveness of the gas supply to gas prices; and that a producer does not explore on the expectation of a return of its cost plus a return on its investment but on the hope of getting back many times what it expends as a reward for its gambler's risk. No doubt these are the economic facts of the industry.

The divorce of commodity value from costs was suggested by Justice Jackson in his dissent in Hope. He commented that a producer would have difficulty showing the invalidity of a fixed commodity value so long as it voluntarily continued to sell its product in interstate commerce.[56] One difficulty with this suggestion is that once

[55] By "last clean rate" is meant the last rate in effect pursuant to a permanent certificate not subject to any refund obligation.

[56] 320 U.S. 591, 652.

the gas is committed no withdrawal from interstate movement is possible without Commission approval.[57] A producer can stop exploration and development if it is dissatisfied with price but the interstate sales go on with a continuing impact of cost on price and of price on exploration and development. In any event the majority rejected the proposal and held that under the just and reasonable standard of the Act a regulated company is entitled to revenue for operating expenses and capital costs and to a return "commensurate with returns on investments in other enterprises having corresponding risks."[58] These standards cannot be met without consideration of costs and revenues. In our opinion the Hope construction of the statutory standard casts serious doubts on the validity of the adoption of a contract-based commodity value.

The alternate argument of the Continental Group is that if the rates are to be determined on a composite cost-of-service basis, the revenue requirements of the industry must be found and rates fixed to meet those requirements. In Second Phillips the Court particularly noted the assurance of the Commission that "composite cost-of-service data will be considered in the area rate proceedings."[59] Consideration of such data does not eliminate consideration of other factors. At the same time Second Phillips did not reject the end result test of Hope. Instead it quoted a portion of that opinion which said among other things that "it is the result reached not the method employed which is controlling."[60]

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[57] Section 7(b) of the Act. See also Sunray Mid-Continent Oil Co. v. Federal Power Commission, 364 U.S. 137, 156.

[58] 320 U.S. 591, 603.

[59] 373 U.S. 294, 310.

[60] Id. at 309.

The Commission rejected both alternatives of the Continental Group. It said that commodity value established by contracts may not be used because of the absence of effective competition; and it emphasized that it took into consideration factors other than costs. The record does not disclose what these other factors were but they must have had some economic basis. The Commission held that its ceiling prices provided a "fair relationship" between consumer prices and producer costs. Fair relationship is pertinent but it is only part of the end result test. We do not know the producers' costs or revenue requirements. We do not know the economic factors which either require or permit departure from costs and revenues. The end result test is not satisfied by a reliance on unknowns.

We have accepted the Commission's conclusion that contract rates should not be used. The trouble is that the Commission decision rides two horses and we have no way of knowing the outcome of the race. It uses composite cost-of-service evidence, engrafts economic factors on top, and comes out with a rate which it justifies on a fair relationship basis. We have the problem of how in such circumstances a court can determine whether the just and reasonable standard of §§ 4 and 5 has been met. The answer is not found in the record before us.

The facts sustaining the conclusion of fair relationship must be found. The Commission did not make those findings and indeed it could not have done so because of the failure of the record to disclose the revenue impact of the adjustments in area rates to reflect quality differentials. Whether rate reductions because of quality deficiencies are a risk or a cost, the answer comes out the same. If they are a risk, we do not know the rate of return. If they are a cost, we do not know whether the revenue received will equal the reasonable revenue requirements. We believe that under Hope, and under Second Phillips, the area producers, as a group, are entitled to recover their prudent operating expenses and capital costs with a return com-

mensurate to the risk and sufficient to attract capital. Satisfaction of this requirement must appear through appropriate findings based on substantial evidence. These cannot be made on the record presented. The decision of the Commission is not saved by the special exemption provisions which we find to be insufficient and unsatisfactory.

Rate making under the Act has produced a superabundance of delay and litigation. Much gas has moved through the pipelines since the First Phillips decision. We wonder if the time has not come for the establishment of a better rapport among the Commission, the consumers, the distributors, the pipelines, and the producers. Some practical means of resolving the economic and legal issues is highly desirable. The Commission has approved many settlements. The use of this procedure may well be explored further in an effort to obtain a true "balancing of the investor and the consumer interests." [61]

One point remains to be mentioned. Eleven motions for leave to adduce additional evidence were filed with us by various producers. We deferred all to the hearing on the merits. In view of the disposition which we make of the cases we see no reasons to explore evidentiary problems which may arise on remand. The Commission will hold such additional hearings as are needed to determine the effect of the quality adjustments, and to determine the group revenues and the group revenue requirements. It will make appropriate findings on these matters. The order based thereon shall contain an adequate provision for special exemptions. We decline to make advance rulings on the procedures to be followed or on the evidence to be received.

The motions to adduce additional evidence are severally denied. The petitions to review are severally granted and the cases are all remanded to the Commission for further proceedings consistent with this opinion.

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[61] 320 U.S. 591, 603.

APPENDIX B

IN THE UNITED STATES COURT OF APPEALS
FOR THE TENTH JUDICIAL CIRCUIT
SITTING AT DENVER, COLORADO

Thirteenth Day, January Term,
Friday, January 20th, 1967.

PRESENT: Honorable Jean S. Breitenstein, Circuit Judge, and other officers as noted on the 19th day of January, 1967.

Before Honorable David T. Lewis, Honorable Jean S. Breitenstein and Honorable Delmas C. Hill, Circuit Judges.

8495

SUN OIL COMPANY, *Petitioner,*

v.

FEDERAL POWER COMMISSION, *Respondent.*

On Petition to Review an Order of the Federal Power Commission.

This cause came on to be heard on petition to review an order of the Federal Power Commission and motion to adduce additional evidence and was argued by counsel.

On consideration whereof, it is ordered by this court that the motion to adduce additional evidence is hereby denied. The petition to review is granted and the case is remanded to the Commission for further proceedings consistent with the opinion of the court.

A true copy as of record,

TESTE:

WILLIAM L. WHITTAKER
Clerk.

APPENDIX C

1. The Administrative Procedure Act, Section 7(c), 60 Stat. 241, 5 U.S.C. 1006(c) provides as follows:

(c) EVIDENCE.—Except as statutes otherwise provide, the proponent of a rule or order shall have the burden of proof. Any oral or documentary evidence may be received, but every agency shall as a matter of policy provide for the exclusion of irrelevant, immaterial, or unduly repetitious evidence and no sanction shall be imposed or rule or order be issued except upon consideration of the whole record or such portions thereof as may be cited by any party and as supported by and in accordance with the reliable, probative, and substantial evidence. Every party shall have the right to present his case or defense by oral or documentary evidence, to submit rebuttal evidence, and to conduct such cross-examination as may be required for a full and true disclosure of the facts. In rule making or determining claims for money or benefits or applications for initial licenses any agency may, where the interest of any party will not be prejudiced thereby, adopt procedures for the submission of all or part of the evidence in written form.

2. The Natural Gas Act, Sections 4 and 5(a), 52 Stat. 822-3, 15 U.S.C. 717c-717d(a) provides as follows:

SEC. 4. (a) All rates and charges made, demanded, or received by any natural-gas company for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges, shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful.

(b) No natural-gas company shall, with respect to any transportation or sale of natural gas subject to the jurisdiction of the Commission, (1) make or grant any undue pref-

erence or advantage to any person or subject any person to any undue prejudice or disadvantage, or (2) maintain any unreasonable difference in rates, charges, service, facilities, or in any other respect, either as between localities or as between classes of service.

(c) Under such rules and regulations as the Commission may prescribe, every natural-gas company shall file with the Commission, within such time (not less than sixty days from the date this act takes effect) and in such form as the Commission may designate, and shall keep open in convenient form and place for public inspection, schedules showing all rates and charges for any transportation or sale subject to the jurisdiction of the Commission, and the classifications, practices, and regulations affecting such rates and charges, together with all contracts which in any manner affect or relate to such rates, charges, classifications, and services.

(d) Unless the Commission otherwise orders, no change shall be made by any natural-gas company in any such rate, charge, classification, or service, or in any rule, regulations, or contract relating thereto, except after thirty days' notice to the Commission and to the public. Such notice shall be given by filing with the Commission and keeping open for public inspection new schedules stating plainly the change or changes to be made in the schedule or schedules then in force and the time when the change or changes will go into effect. The Commission, for good cause shown, may allow changes to take effect without requiring the thirty days' notice herein provided for by an order specifying the changes so to be made and the time when they shall take effect and the manner in which they shall be filed and published.

(e) Whenever any such new schedule is filed the Commission shall have authority, either upon complaint of any State, municipality, State commission, or gas distributing

company[1a] or upon its own initiative without complaint, at once, and if it so orders, without answer or formal pleading by the natural-gas company, but upon reasonable notice, to enter upon a hearing concerning the lawfulness of such rate, charge, classification, or service; and, pending such hearing and the decision thereon, the Commission, upon filing with such schedules and delivering to the natural-gas company affected thereby a statement in writing of its reasons for such suspension, may suspend the operation of such schedule and defer the use of such rate, charge, classification, or service, but not for a longer period than five months beyond the time when it would otherwise go into effect;[1a] and after full hearings, either completed before or after the rate, charge, classification, or service goes into effect, the Commission may make such orders with reference thereto as would be proper in a proceeding initiated after it had become effective. If the proceeding has not been concluded and an order made at the expiration of the suspension period, on motion of the natural-gas company making the filing, the proposed change of rate, charge, classification, or service shall go into effect. Where increased rates or charges are thus made effective, the Commission may, by order, require the natural-gas company to furnish a bond, to be approved by the Commission, to refund any amounts ordered by the Commission, to keep accurate accounts in detail of all amounts received by reason of such increase, specifying by whom and in whose behalf such amounts were paid, and, upon completion of the hearing and decision, to order such natural-gas company to refund, with interest, the portion of such increased rates or charges by its decision found not justified. At any hearing involving a rate or charge sought to be increased, the burden of proof to show that the increased rate or charge is just and reasonable shall be upon the natural-gas com-

---

[1a] Subsection 4 (e) was amended May 21, 1962 by Public Law 87-454, 87th Congress, 2d Session [S. 1595], 76 Stat. 72.

pany, and the Commission shall give to the hearing and decision of such questions preference over other questions pending before it and decide the same as speedily as possible. [52 Stat. 822 (1938); 76 Stat. 72 (1962); 15 U.S.C. § 717c]

SEC. 5. (a) Whenever the Commission, after a hearing had upon its own motion or upon complaint of any State, municipality, State commission, or gas distributing company, shall find that any rate, charge, or classification demanded, observed, charged, or collected by any natural-gas company in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order: *Provided, however,* That the Commission shall have no power to order any increase in any rate contained in the currently effective schedule of such natural-gas company on file with the Commission, unless such increase is in accordance with a new schedule filed by such natural-gas company; but the Commission may order a decrease where existing rates are unjust, unduly discriminatory, preferential, otherwise unlawful, or are not the lowest reasonable rates.

BRIEF IN OPPOSI-TION TO PETITION FOR A WRIT OF CERTIORARI

No. 1292

SUN OIL COMPANY, *Petitioner*,

v.

FEDERAL POWER COMMISSION.

No. 1293

PEOPLE OF THE STATE OF CALIFORNIA, ET AL., *Petitioners*,

v.

SKELLY OIL COMPANY, ET AL.

No. 1295

PACIFIC GAS AND ELECTRIC COMPANY, ET AL., *Petitioners*,

v.

SKELLY OIL COMPANY, ET AL.

No. 1342

FEDERAL POWER COMMISSION, *Petitioner*,

v.

SKELLY OIL COMPANY, ET AL.

On Petitions for a Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

ANSWER OF SUN OIL COMPANY TO JOINT BRIEF IN OPPOSITION OF INDICATED RESPONDENTS

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1966

No. 1292

SUN OIL COMPANY, *Petitioner*,

v.

FEDERAL POWER COMMISSION.

No. 1293

PEOPLE OF THE STATE OF CALIFORNIA, ET AL., *Petitioners*,

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SKELLY OIL COMPANY, ET AL.

No. 1295

PACIFIC GAS AND ELECTRIC COMPANY, ET AL., *Petitioners*,

v.

SKELLY OIL COMPANY, ET AL.

No. 1342

FEDERAL POWER COMMISSION, *Petitioner*,

v.

SKELLY OIL COMPANY, ET AL.

On Petitions for a Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

---

ANSWER OF SUN OIL COMPANY TO JOINT BRIEF IN OPPOSITION OF INDICATED RESPONDENTS

Comes now Sun Oil Company ("Sun") in answer to the joint brief in opposition to its petition for writ of certiorari in No. 1292, which brief was filed on June 1, 1967 by a group of natural gas producers that are respondents in certain of the *Permian Basin Area Rate* cases (hereinafter referred to as "Texaco, *et al.*"). Texaco, *et al.* are respondents in Nos. 1293, 1295 and 1342 in which their brief is captioned; however, they are *not* respondents to Sun's petition in No. 1292 or to several other petitions to which the brief is also directed (fn. p. 1). Sun submits that the Texaco, *et al.* brief is materially in error where it seeks to characterize Sun's position, as well as in its characterization of the holdings of the court below and the holding of this Court in *Second Phillips, Wisconsin* v. *Federal Power Commission,* 373 U.S. 294 (1963).

(1) Texaco, *et al.,* erroneously groups Sun with Hunt Oil Company and Superior Oil Company and claims that this group challenges the constitutional and statutory basis for area rates *per se* (pp. 2, 14). To the contrary, Sun does not claim that area rates are *per se* improper. Instead Sun submits that group ratemaking may be undertaken only if proper consideration is given to the individuals in the group such as by the use of typical and representative evidence, as held by this Honorable Court in a long line of cases extending from the *New England Divisions Case*[1] through the Court's very recent decision in *Chicago and North Western Railway Co.* v. *The Atchison, Topeka and Santa Fe Railway Co.,* 35 L.W. 4481, 4485 (May 29, 1967).

(2) The Texaco, *et al.* brief in opposition also ignores Sun's fundamental position that there are important due process errors in these proceedings involving the basic data used. Texaco, *et al.* brief argues

[1] *Akron, C. & Y. R. Co.* v. *United States,* 261 U.S. 184 (1923).

that the Court of Appeals deemed it premature to review "subsidiary substantive issues" (p. 9), and that these issues are rate design issues which the court below "could not" review because they were buried in a "'turmoil of numbers.'" (pp. 9-10) Furthermore, the Texaco, *et al.* brief claims that the Tenth Circuit refused to be drawn into such a review because of the "patent inadequacy of the record and findings before it" (p. 10). This is not Sun's understanding of the Tenth Circuit's decision.

The issues Sun presents, and which the court below referred to in using the term "turmoil of numbers," are not "subsidiary" issues. Rather they are fundamental due process questions inherent in the Commission's group ratemaking method. Moreover, these due process issues go to the basic data used rather than to rate design as Texaco, *et al.* state. In addition the court below did not hold that review of these issues was premature, that it *could not* review these issues, or that the record and findings were so inadequate as to preclude review. Rather, the Court simply said that it *would not* review these issues because of their complexity. As noted in Sun's petition in No. 1292 (p. 15), this in effect constitutes affirmance of the Commission by default. The propriety of the Tenth Circuit's action is now open for this Court's review.

(3) The brief of Texaco, *et al.* (p. 14) is misleading in stating that the statutory arguments advanced by Sun were "not accepted" by this Court in *Second Phillips, Wisconsin* v. *Federal Power Commission, supra.* As shown by Sun's petition in No. 1292 (pp. 5 and 14) and further as found by the Tenth Circuit below (Appendix A to Sun's petition, p. 14a), this Court did not in *Second Phillips* rule on the propriety of the Commission's group ratemaking process as adopted herein.

This Court, in *Second Phillips* (with four justices dissenting), expressed a hope that the Commission could enter upon group ratemaking consistent with the statute and the constitution. It is Sun's position, however, that this Court's statements did not exempt the Commission from well-recognized constitutional and statutory limitations to group ratemaking, and these limits were not adhered to by the Commission. *Second Phillips* was not as an open-ended endorsement of whatever group method the Commission chose to employ and whatever evidence the Commission chose to rely on in pursuit of that method. Accordingly, Sun proposes to show this Court that the Commission in this initial attempt to enter upon group ratemaking wholly ignored fundamental due process considerations, as well as the constitutional and statutory limitations upon group ratemaking, not the least of which were those recognized in this Court's *Chicago and North Western* decision.

For the reasons stated above, Sun submits that its petition for a writ of certiorari is properly before this Honorable Court and should be granted.

Respectfully submitted,

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June 6, 1967

PETITION FOR A WRIT OF CERTIORARI

APR 19 1967
JOHN F. DAVIS, CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1966

No. [redacted]100

PEOPLE OF THE STATE OF CALIFORNIA and PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA,

Petitioners,

vs.

SKELLY OIL COMPANY, PHILLIPS PETROLEUM COMPANY, WARREN PETROLEUM CORPORATION, MOBIL OIL CORPORATION (formerly Socony Mobil Oil Company, Inc.), PAN AMERICAN PETROLEUM CORPORATION, NORTHERN NATURAL GAS PRODUCING COMPANY,

[*Continued on Inside Cover*]

Petition for a Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

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April 17, 1967

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[*Continued from Cover*]

STANDARD OIL COMPANY OF TEXAS, a Division of
Chevron Oil Company,
TEXACO INC.,
HUNT OIL COMPANY jointly with
H. L. Hunt,
Lamar Hunt,
N. B. Hunt,
W. H. Hunt,
Secure Trusts,
Caroline and Loyd B. Sands,
Caroline Hunt Trust Estate,
Lyda Hunt-Caroline Trusts,
Lyda Hunt-Bunker Trusts,
Lyda Hunt-Lamar Trusts,
Lyda Hunt-Herbert Trusts,
Lyda Hunt-Margaret Trusts
(formerly Estate of Lyda Bunker Hunt, Deceased),
Hunt Industries
(formerly Estate of Lyda Bunker Hunt, Deceased), and
Placid Oil Company,
HUMBLE OIL & REFINING COMPANY,
SHELL OIL COMPANY,
THE ATLANTIC RICHFIELD COMPANY (formerly
The Atlantic Refining Company) jointly with
Dorchester Gas Producing Company,
Southland Royalty Company, and
Westates Petroleum Company,
CONTINENTAL OIL COMPANY jointly with
Sunray DX Oil Company,
Sinclair Oil & Gas Company,
Cabot Corporation,
Sohio Petroleum Company,
Joseph E. Seagram & Sons, Inc.,
Joseph E. Seagram & Sons dba
Texas Pacific Oil Company,
Gulf Oil Corporation,
Murphy Oil Corporation,
The Nueces Company,
Samedan Oil Corporation,

[*Continued from Inside Cover*]

Cities Service Oil Company
(formerly Cities Service Petroleum Corporation),
Cities Service Production Company
(now merged with Cities Service Oil Company),
Columbian Fuel Corporation,
Amerada Petroleum Corporation,
Union Oil Company of California and as successor to
The Pure Oil Company,
Tidewater Oil Company,
Reef Corporation, and
William A. & Edward R. Hudson, Joint Operators,
MARATHON OIL COMPANY,
SUN OIL COMPANY,
INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA,
THE BRITISH-AMERICAN OIL PRODUCING COMPANY,
UNION TEXAS PETROLEUM, a Division of
Allied Chemical Corporation,
MIDHURST OIL CORPORATION,
THE SUPERIOR OIL COMPANY,
PERRY R. BASS jointly with
Panther City Investment Co.,
Bass Bros. Enterprise, Inc.,
Perry R. Bass, Incorporated, and
Richardson Oils, Inc.,
COLUMBIAN CARBON COMPANY jointly with
Coltexo Corporation,
THE STATE OF TEXAS,
BIG CHIEF DRILLING COMPANY jointly with
King-Stevenson Oil Co., Inc., and
Service Drilling Company,
TEXAS INDEPENDENT PRODUCERS & ROYALTY OWNERS
ASSOCIATION jointly with
West Central Texas Oil and Gas Association,
STATE OF NEW MEXICO,
GULF OIL CORPORATION, and
J. C. BARNES, *et al.*, ***Respondents.***

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In the Supreme Court of the United States

OCTOBER TERM, 1966

No. .....

PEOPLE OF THE STATE OF CALIFORNIA and PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA,
Petitioners,

vs.

SKELLY OIL COMPANY, et al.,
Respondents.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

The Petitioners, the People of the State of California and the Public Utilities Commission of the State of California, respectfully pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Tenth Circuit entered on January 20, 1967.[1]

1. Petitioners were intervenors in support of the Federal Power Commission, respondent in the court below. Respondents on this petition for a writ of certiorari were the petitioners in the court below.

OPINIONS BELOW

The opinion of the Court of Appeals is not yet reported, and is printed in Appendix A.[2] The Federal Power Commission's Opinion Determining Just and Reasonable Rates for Natural Gas Producers in the Permian Basin, Docket No. AR61-1, *et al.* (Opinion No. 468), and related orders, issued on August 5, 1965 (J.A. 516d-838d, 37s-40s),[3] are reported at 34 FPC 159, 418, and 424 respectively; and its Opinion and Order Denying Applications for Rehearing of Opinion No. 468, Docket No. AR61-1, *et al.* (Opinion No. 468-A), issued on October 4, 1965 (J.A. 1105d-1136d), are reported at 34 FPC 1068. Opinion Nos. 468 and 468-A are also printed in Appendix A.

JURISDICTION

The judgment of the Court of Appeals was entered on January 20, 1967. Petitioners herein did not petition for rehearing before the Court of Appeals.[4] The jurisdiction of this Court is invoked under the provisions of 28 U.S.C. 1254(1) and Section 19(b) of the Natural Gas Act.[5]

The following respondents have filed petitions for rehearing before the Court of Appeals: Shell Oil Company and

---

2. Printed separately in Appendices to Petition for Writ of Certiorari.

3. The Joint Appendix contains thirteen volumes which are paginated as follows: Volumes I through V, which contain only testimony, are paginated 1-1908. Volumes VI through VIII, which contain exhibits presented during the hearings, are paginated 1e-1146e. Volumes IX through XI, which contain pleadings, orders, and opinions, are paginated 1d-1157d. There are also two small volumes—a supplement numbered 1s-40s, and a separate volume containing the table of contents for Volumes I through XI.

4. Rule 26 of the United States Court of Appeals for the Tenth Circuit allows twenty days after judgment or decision to petition for rehearing.

5. Act of June 21, 1938, c. 556, § 19, 52 Stat. 831, as amended 15 U.S.C. 717(r) (1958).

Phillips Petroleum Company in Docket Nos. 8409 and 8489; Warren Petroleum Corporation, Gulf Oil Corporation, The British-American Oil Producing Company, Humble Oil & Refining Company, Cities Service Oil Company, Cities Service Production Company, Coltexo Corporation, Columbian Fuel Corporation, and Columbian Carbon Company in Docket Nos. 8440, 8493, 8534, 8497, 8488, 8493, and 8517; Standard Oil Company of Texas in Docket No. 8479; Mobil Oil Corporation (formerly Socony Mobil Oil Co., Inc.) and Northern Natural Gas Producing Company in Docket Nos. 8455, 8460, and 8588; Pan American Petroleum Corporation and Sinclair Oil & Gas Company in Docket Nos. 8458 and 8493; Texaco Inc., Amerada Petroleum Corporation, Atlantic Richfield Company, Southland Royalty Company, Westates Petroleum Company, Dorchester Gas Producing Company, Sunray DX Oil Company, Marathon Oil Company, Sohio Petroleum Company, and Tidewater Oil Company in Docket Nos. 8482, 8541, 8493, 8542, 8490, 8540, and 8494. These petitions for rehearing are pending at the present time. Petitioners will advise this Court of the determination of these petitions by the Court of Appeals as soon as possible.

QUESTIONS PRESENTED

1. In determining just and reasonable area rates under Sections 4 and 5 of the Natural Gas Act, must the Federal Power Commission, in order to satisfy the "end result" test set forth in *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591 (1944), determine the allowable area cost of service for the gas produced in the area, including an allowance for exploration to meet future demand for gas, find that such cost of service constitutes the area revenue requirement, and establish rates which will recover such revenue requirement; or may it determine area rates

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which establish a fair relationship between the revenues derived from the rates prescribed and the allowable area cost of service?

2. Where *Federal Power Commission v. Sierra Pacific Power Company*, 350 U.S. 348 (1956), holds that voluntarily made contract rates, which are below the Federal Power Commission's subsequently determined just and reasonable rates, are not required to be raised to the same level as the just and reasonable rates unless the public interest so necessitates, must the Commission raise these low contract rates for the purpose of insuring that area revenues equal the Commission's determination of allowable area costs?

3. In establishing group ceiling rates applicable to pipeline quality gas, is the Commission's rate-of-return allowance of 12 percent adequate where specific recognition was given to the fact that lower quality gas commanding a lesser price might be found and where this possibility was treated as an additional risk?

4. Where the Federal Power Commission establishes just and reasonable area rates, and there is a possibility that some producers may require special relief from these rates, did the Commission err by establishing a special relief provision which announces that such producers may petition for relief, but which does not specify detailed guidelines for such relief?

5. Is the Federal Power Commission's area rate decision so vague and unclear with regard to the establishment of the "Btu gap" in its Btu quality standard that clarification is required?[6]

6. If certiorari is granted, we also reserve the right to argue two additional questions:
   1. Whether the Commission gave adequate notice that it would prescribe quality standards in this proceeding.
   2. Whether the area rates fixed by the Commission are just and reasonable within the meaning of the Natural Gas Act. (This question covers the issues which the court below failed to reach due to its remand order. Petitioners will ask this Court to affirm the Commission's decision in all respects.)

STATUTE INVOLVED

The relevant provisions of the Natural Gas Act, 52 Stat. 821, as amended, 15 U.S.C., Sections 717-717w, are set forth in Appendix B.

STATEMENT OF THE CASE

The opinions and orders of the Federal Power Commission (Commission) remanded by the court below establish just and reasonable rates for jurisdictional gas sold in a specific geographic area—the Permian Basin of west Texas and southeastern New Mexico. Opinion Nos. 468 and 468-A represent the first attempt by the Commission to regulate the rates of independent producers on an area basis. Area rate making under the Natural Gas Act is the product of a long administrative and legal struggle to find a workable and effective approach to producer regulation.

A. Historical Background

On June 7, 1954, this Court, in *Phillips Petroleum Company v. Wisconsin*, 347 U.S. 672 (1954), decided that independent producers are natural gas companies within the meaning of the Natural Gas Act. Sales by producers for resale in interstate commerce are therefore subject to the regulatory jurisdiction of the Commission.

In response to its newly found obligation to regulate the rates of independent producers, the Commission went forward under Section 5(a) of the Act with an investigation of the rates and charges of Phillips Petroleum Company (Phillips). On September 28, 1960, the Commission issued

Opinion No. 338[7] terminating both the rate investigation and the consolidated Section 4(e) rate increase proceedings.[8]

The Commission rejected individual company cost-of-service rate making as a basis for fixing Phillips' future rates under Section 5(a), and announced that it would attempt to regulate producers through the development of area rates. At the same time the Commission issued its Statement of General Policy No. 61-1.[9] The purpose of the policy statement was to announce price levels for the various gas producing areas of the nation which would provide guidance to the Commission in certificating initial sales of gas and in suspending rate increase applications. The policy statement guideline price levels have served as an interim form of producer regulation pending the issuance of the Commission's first area rate decision.

Petitioners, the People of the State of California and the Public Utilities Commission of the State of California (California), the states of New York and Wisconsin, as well as several eastern gas distributing utilities, sought review of Opinion No. 338 in the Court of Appeals for the District of Columbia Circuit. The Court of Appeals denied the petitions for review, affirming Opinion No. 338.[10] On May 20, 1963, this Court affirmed the judgment of the Court of Appeals. *Wisconsin v. Federal Power Commission,* 373 U. S. 294 (1963). This Court held that individual company cost-of-service rate making was not the sole method of

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7. *Phillips Petroleum Company,* Docket Nos. G-1148, *et al.,* 24 FPC 537 (1960).

8. Two of the Section 4(e) dockets were left open, pending determination of issues involving contractual support for the rate increases in question.

9. 24 FPC 818 (1960), 18 C.F.R. 2.56, as amended.

10. *Wisconsin v. Federal Power Commission,* 303 F. 2d 380 (D.C. Cir. 1961).

natural gas rate regulation, and although the question of the legality of area rate making was not before the Court for decision, the Commission was not prohibited from commencing the use of this method.

B. The Proceeding Before the Commission

The Commission selected the Permian Basin as the first area with respect to which just and reasonable producer rates would be determined by use of the area rate making technique. On December 23, 1960, the Commission instituted a Section 5(a) investigation of the rates of producers relating to jurisdictional sales of natural gas produced in the Basin. Existing Section 4(e) rate increase proceedings and several Section 7 certificate proceedings involving gas produced in the Basin were consolidated with the investigation. Thus the Commission would be in a position to determine just and reasonable area rates for the future and to apply such area rates (1) in determining whether suspended increased rates, collected subject to refund, should be allowed or refunded in whole or in part, and (2) in determining the price at which an initial sale should be certificated in terms of the public convenience and necessity.

The proceeding commenced on October 11, 1961, and ultimately involved 251 days of hearing, a transcript containing 30,369 pages, and some 337 exhibits. On September 12, 1963, the hearings were concluded. Briefs were filed by the parties, and the matter was submitted to the Examiner for an initial decision.

1. THE PRESIDING EXAMINER'S INITIAL DECISION

The initial decision was issued on September 17, 1964.

The Examiner determined area ceiling rates for various types of gas within two major categories—new and old

gas. The fixing of prices for new and old gas has come to be known as the two-price system.

The Examiner found that producers could direct, to some extent, their exploration activities in a search for either gas or oil. This meant that a price for new gas-well gas could serve the economic function of eliciting supplies of gas, because the price of oil would play no part in motivating the separately determined search for gas reservoirs.[11] In accordance with this economic approach, the price for new gas-well gas would be based on higher current costs—as opposed to lower historical costs. Thus the rate fixed for new gas-well gas would be higher than the rate fixed for old gas-well gas. This higher rate could therefore serve as an incentive to producers to explore for gas reservoirs and to dedicate new supplies of gas to the interstate market.

The Examiner selected December 23, 1960,[12] as the date dividing new and old gas.

The core of the initial decision was the Examiner's determination of an area ceiling price for new gas-well gas. The estimated national current cost of finding and producing new gas-well gas, including return at 12 percent, was related to the Permian Basin area by the application of a value-based geographical discount. This resulted in an average area price. A "gold standard" allowance was added to the average price to obtain the area ceiling price.

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11. Gas-well gas is gas produced from gas only and gas condensate reservoirs. It is gas not found in association with crude oil. Gas-well gas is to be distinguished from casinghead gas, or oil well gas. Casinghead gas is produced in conjunction with oil from crude oil reservoirs. Either casinghead gas or gas-well gas from gas condensate reservoirs may be sent through a gasoline plant where liquid hydrocarbons are extracted and later sold. The gas emanating from the tailgate of the plant is known as residue gas.

12. This was the date on which the proceedings were instituted.

"The gold standard is the premium above the average price for superior quality and value." (J.A. 246d.)

The area ceiling price for new gas-well gas governed the area ceiling price for new residue gas, i.e., residue gas derived from new gas-well gas. Separate rates were also determined for new casinghead gas.

The area ceiling price for old gas-well gas was determined by "deflating" the cost based revenue standard for new gas-well gas. The area ceiling prices for old residue and old casinghead gas were, in turn, related to the old gas-well gas price in terms of relative value.[13]

It should be noted that, although determining area ceiling rates by inclusion of a gold standard for superior quality and value, the Examiner nevertheless failed to provide for deductions from the ceiling price, where gas was of less than pipeline quality.[14]

2. THE COMMISSION'S DECISION

Many parties having filed exceptions to the initial decision, the Commission heard oral argument on February 8, 9,

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13. The area ceiling prices determined by the Presiding Examiner were:

	New (Cents per Mcf.)	Old (Cents per Mcf.)
Gas-well gas	16.75	13.5
Residue gas	16.75	13.5
Casinghead gas	11.00	10.0

14. The foregoing description of the Examiner's initial decision has been confined to a brief review of the derivation of the area ceiling rates. The Examiner also determined minimum rates for gas-well gas and residue gas (9 cents per Mcf) and for casinghead gas (7 cents per Mcf). The decision covered other subjects, such as exemption from regulation for small producers, prohibition of certain price escalation clauses in producer contracts, computation of refunds on an area basis, and provision for special relief for individual producers where imposition of the group rates would lead to serious injustice.

and 10, 1965. Its decision, Opinion No. 468, was issued on August 5, 1965.

The Commission adopted the two-price system and determined base area ceiling rates for new gas-well gas and old (flowing) gas.[15] The Commission selected January 1, 1961, as the date dividing new and flowing gas. Separate prices were not established for types of gas, i.e., gas-well gas, residue gas, and casinghead gas.

In determining the base area rate for new gas-well gas, the Commission utilized the estimated national current cost of finding and producing new gas-well gas, including return computed at a rate of 12 percent. The Commission rejected the use of a geographical discount and a gold standard premium.

In determining the base area ceiling price for flowing gas, the Commission relied upon the 1960 area historical cost of service, including a return of 12 percent, applicable to flowing gas-well gas. This cost was used as a yardstick for the pricing of flowing residue and all casinghead gas.

The base area ceiling rates were to apply to sales of pipeline quality gas. Downward adjustments from the base area rates were to be made for deviations from the pipeline quality standards defined by the Commission for hydrogen

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15. These Permian Basin base area rates are:

Texas, Including Production Taxes	
New Gas-Well Gas*	16.5 cents per Mcf.
Flowing Gas	14.5 cents per Mcf.
New Mexico, Production Taxes To Be Added	
New Gas-Well Gas*	15.5 cents per Mcf.
Flowing Gas	13.5 cents per Mcf.

*The ceiling price for new gas-well gas is applicable to residue gas derived from new gas-well gas.

Flowing gas includes all gas except new gas-well gas and residue gas derived therefrom.

sulphide, sulphur, carbon dioxide, water, and delivery pressure. Both a downward and an upward adjustment were prescribed to reflect quality differentials respecting Btu content. The Btu adjustment, either upward or downward, would apply only to the base area rates for new gas-well gas and residue gas derived therefrom. The rate resulting from the application of the quality adjustments became the applicable area rate for the particular sale in question.

A minimum base area rate of 9 cents per Mcf for all gas subject to quality adjustments was prescribed.

Special treatment was provided for small producers, whom the Commission defined as producers with sales of less than 10 million Mcf of jurisdictional gas per year. They may receive small producer certificates which authorize all future small producer sales in the area at or below the applicable area ceiling rate. They will not have to obtain separate certificates for each sale, or file the normal annual reports required from large producers.

Provision was made by the Commission for an individual producer to obtain special relief from the imposition of the area rates where such a producer could make a proper showing justifying such treatment, but the Commission made clear that it would not allow this provision to become an escape clause to return to individual company rate making.

The Commission ordered a moratorium on the filing of rate increases above the applicable area rate until January 1, 1968.

With respect to Section 4(e) dockets consolidated in the proceedings, the Commission provided for refunds of increased rates collected subject to refund prior to September 1, 1965, in excess of the applicable area rates. Payment of these Section 4(e) refunds was stayed by the Commission pending judicial review of its decision (J.A. 696d, 1123d).

3. APPLICATIONS FOR REHEARING

Numerous applications for rehearing were filed by the producers. Rehearing was also sought by California (J.A. 1002d-1026d). On October 4, 1965, the Commission issued Opinion No. 468-A, denying all applications for rehearing. However, in response to objections made by producers, the Commission modified the quality standards prescribed in Opinion No. 468 by reducing the delivery pressure standard, and by applying the downward and upward Btu adjustments to flowing gas. It also dealt with the producers' contentions that jurisdictional revenues must equal jurisdictional costs.

C. The Proceeding in the Court Below

Pursuant to Section 19(b) of the Natural Gas Act, the producers, related producer associations, and the states of New Mexico and Texas, respondents herein, filed in the Court of Appeals for the Tenth Circuit petitions to review Commission Opinions Nos. 468 and 468-A.

California intervened in these review proceedings and took the position that the Commission's decision should be affirmed as a lawful exercise of the Commission's authority under Sections 4 and 5 of the Natural Gas Act to fix just and reasonable rates.

On January 20, 1966, the court below stayed Opinions Nos. 468 and 468-A, with certain exceptions, until thirty days after its decision on the merits or until thirty days after the determination of any petition for rehearing.[16] On

16. The court below did not stay the provisions of the Commission's decision which require filing of rate reduction supplements, quality statements, and refund reports, but these filings are not to become operative until termination of the stay order. It also ordered the producers to set aside for possible refund all amounts collected subsequent to September 1, 1965, in excess of the rates determined to be just and reasonable.

January 20, 1967 it rendered its decision remanding the proceedings to the Commission for further hearings. On February 1, 1967 the Commission moved for a stay of mandate and suggested the extension of the stay order. The court below, on February 15, 1967, extended its stay order until thirty days after termination of the proceedings in this Court in the event that petitions for writ of certiorari are filed.[17]

The Court of Appeals affirmed the Commission's authority to adopt the area rate method of regulation. Furthermore, it unequivocally rejected the producers' contention that effective competition exists in the natural gas production industry. Instead, it concluded that the Natural Gas Act's standard of just and reasonable rates and *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591 (1944),[18] required consideration of costs and revenues and rejection of the producers' contract-based commodity value approach. However, the court concluded that the Commission failed to comply fully with the legal requirements for rate making under the Natural Gas Act as determined in the *Hope* case and in *Wisconsin v. Federal Power Commission*, 373 U.S. 294 (1963).[19] It also concluded that certain other provisions in the Commission's opinions and orders were vague.

With regard to the question of compliance with the *Hope* and *Second Phillips* cases, the court below held that the Commission had "rejected the end result test and adopted a fair relationship standard." (App. A, p. 411.) It

17. The court did not rule on the Commission's motion to stay mandate due to the pending petitions for rehearing. (Rule 31b, U.S. Court of Appeals for the Tenth Circuit.)

18. Hereinafter referred to as *Hope*.

19. Hereinafter referred to as *Second Phillips*.

could not ascertain from the Commission's decision the producers' revenue requirements, or the economic factors which permit departure from consideration of costs and revenues, and therefore it could not accept the Commission's determination that a "fair relationship" between costs and revenues was sufficient to comply with the "end result" test. It took the position that under the end result test costs and revenues must balance:

> "Nothing in Second Phillips rejects the end result test of Hope. We believe that it applies here and that it is not satisfied by a finding of fair relationship . . .
>
> From the standpoint of the producer the situation is different. It is entitled to recover its prudent operating expenses and capital costs with a return commensurate to the risk and sufficient to attract capital. These requirements must be tested against the record. They may not be brushed aside with a general finding of fair relationship. The Commission concedes that it did not equate jurisdictional costs to jurisdictional revenues. This is obvious because no determination was made of the jurisdictional revenues which the rates will produce." (App. A, pp. 412-13.)

The court ordered that the Commission hold further hearings "to determine group revenues and group revenue requirements," and to make detailed findings to sustain the conclusion of fair relationship. (App. A, pp. 413, 431.)

The court disapproved of the manner in which the Commission treated the problem of price deductions for poor quality gas. The Commission decided that the possibility of finding poor quality gas constituted a risk to the producers and that it should be included in the rate-of-return allowance. The court rejected this position, and held that price deductions to reflect quality deviations are an item

of cost and should be quantified and included "in the applicable base rates instead of hidden in a rate of return allowance." (App. A, p. 423.) Only then, the court held, could it review the adequacy of the rate-of-return allowance.

The court found that the Commission's special relief provision was "insufficient and unsatisfactory." (App. A, p. 430.) This provision indicated that relief would be available for high cost producers who are unable to recover their costs under the applicable area rates. The court agreed with the producers that this relief provision was "so vague and nebulous that neither they nor a court can determine what relief is being granted." (App. A, p. 418.) It directed the Commission to establish relief provisions which "contain guidelines which if followed by an aggrieved producer will permit it to be heard promptly and to have a stay of the general rate order until its claim for exemption is decided." (App. A, p. 419.)

With regard to the quality standard for heating value, the court did not understand why the Commission decided to have the downward adjustment begin at 1,000 Btu and the upward adjustment begin at 1,050 Btu. The court directed that the Commission clarify its reasons for this 50 Btu gap between upward and downward adjustments in price. As for the other quality standards the Commission established, the court did not expressly approve or disapprove them. However, it did refuse to resolve the producers' argument that the imposition of them violated procedural due process because of lack of notice, saying: "We are remanding the case and now everyone has notice." (App. A, pp. 421.)

REASONS FOR GRANTING THE WRIT

The serious regulatory problems created by the decision of the court below require resolution by this Court, which charged the Commission almost thirteen years ago with the duty to regulate natural gas producers. Now this Court should decide whether the Commission's first area rate decision is valid and lawful.

An answer to this question by this Court is of fundamental importance to all parties involved in the long struggle to establish regulation of this industry. To date, no effective method of just and reasonable price regulation of this industry has been enforced. Price uncertainty continues to be the reality—producers do not know what price to which they are entitled, and consumers do not know whether the price they are paying is lawful. Millions of dollars of potential refunds have accumulated and continue to grow. The time and effort invested in this first area rate proceeding are very great—over six years, including 251 days of hearings and 30,369 pages of transcript. Three other area rate proceedings have been completed through the hearing stage.[20] They substantially followed the framework created by the Commission's decision in the proceedings presented here for review. Together with the Permian decision, they will achieve regulation for approximately 70 percent of the interstate sales of natural gas. If the decision of the court below remanding the Commission's decision is correct, then not only the Permian proceeding, but all three other area rate proceedings must be reopened, and the achievement of effective regulation of natural gas producers will be delayed again.

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20. Area Rate Proceeding (Southern Louisiana Area), Docket No. AR61-2; Area Rate Proceeding (Hugoton-Anadarko and Texas Gulf Coast Areas), Docket Nos. AR64-1 and 2.

The decision of the court below constitutes a major judicial precedent under the Natural Gas Act. Unfortunately, it is obscure and contradictory. The court below misconstrued the requirements for rate making as laid down in the *Hope* case and the suggestions relating to area rate making which were made in the *Second Phillips* case. With regard to the question of jurisdictional revenues balancing jurisdictional costs, it seems to require disregard of the principles established by *Federal Power Commission v. Sierra Pacific Power Company*, 350 U.S. 348 (1956).[21] It has departed from the primary principle of the *Hope* case that "it is the result reached, not the method employed, which is controlling" by directing the Commission to treat quality deviations as an item of cost and not as a risk. Finally, the court below has failed to make known to the Commission what it must do in order to correct its decision with regard to the "Btu gap" and the special relief provision. For these reasons, the case fully deserves review here.

1. Due to the National Importance of Effective Producer Regulation, Consumers Need a Decision by This Court on the Validity of Area Rate Making.

The result of the decision by the court below is to overthrow the Commission's time-consuming attempt to establish effective regulation of natural gas producers on an area basis. This result can have only dire consequences for consumers who have been waiting almost thirteen years for effective producer regulation. Rate increase has piled upon rate increase without any final determination of just and reasonable rates. California asks whether or not interminable administrative proceedings—apparently seeking an ideal and perfect method of doing things and always at

21. Hereinafter referred to as *Sierra Pacific*.

great length and consuming long periods of time—are not presently or, at least, will not soon be tantamount to failure to regulate.

The court below makes little or no mention of the primary purpose of the Natural Gas Act, which this Court has said is "to protect consumers against exploitation at the hands of natural gas companies." *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591, 611 (1944); *Phillips Petroleum Company v. Wisconsin*, 347 U.S. 672, 685 (1954). This purpose was reaffirmed in *Sunray Midcontinent Oil Company v. Federal Power Commission*, 364 U.S. 137, 147 (1960), and rephrased in *Atlantic Refining Company v. Public Service Commission of the State of New York*, 360 U.S. 378, 388 (1959): "The Act was so framed as to afford consumers a complete, permanent and effective bond of protection from excessive rates and charges." The direct effect of the lower court's decision will be several more years of delay in achieving effective regulation. It is even possible that upon reopening these proceedings, the Commission and consumers will hear the argument that the 1960 test year has become "too stale" and that a more recent one is required. In this way the producers may yet avoid completely any realistic regulation, and thereby achieve the relief Congress has denied them.

California's need for effective producer regulation is unusually great. California is the largest state in the Union, having a current population in excess of 19,000,000. The State depends on natural gas as the basic source of residential and industrial energy. Not only is gas used directly for space heating, water heating, air conditioning, and cooking, but it provides in large measure the energy used for generating electricity. Unlike other areas of the nation, coal is not an economical alternative to natural gas for meeting

California's energy requirements for space and water heating.

California intervened in the proceedings before the Commission and in the review proceedings in the court below because most of the gas produced in the Permian Basin is consumed in California.[22] The State consumes approximately 11.1 percent of all the gas produced in the United States. Almost 75 percent of the supply of natural gas needed to meet the demands of the California market is furnished from sources beyond the borders of the State, while the remainder is drawn from wells within California. Of the out-of-state supply, 87 percent is transported to California by El Paso Natural Gas Company and Transwestern Pipeline Company from sources in Texas, New Mexico, Oklahoma, and Arizona; and 13 percent is imported from Canada and transported to California by Pacific Gas Transmission Company. Residents of California must ultimately pay the rates determined by the Commission in the orders reviewed by the court below. These orders result in rate reductions and substantial refunds which will benefit ultimate consumers in California.

The delay resulting from the lower court's decision will adversely affect the possibility of any refunds to consumers. As this Court has noted, future refunds cannot and do not fully protect the ultimate consumer of natural gas. In evaluating the effectiveness of future refunds as protection for natural gas consumers, the Supreme Court in *Federal Power Commission v. Tennessee Gas Transmission Company*, 371 U.S. 145, 154 (1962), stated:

> "True, the exaction would have been subject to refund but experience has shown this to be somewhat illusory

22. In 1964 alone, slightly less than 70 percent of the Basin's production dedicated to interstate sales was delivered to the California market.

> in view of the trickling down process necessary to be followed, the incidental cost of which is often borne by the consumer, and in view of the transient nature of our society which often prevents refunds from reaching those to whom they are due."[9] [Footnote omitted.]

Consumers of natural gas have waited almost five years for the relief provided them by the Commission in Opinion Nos. 468 and 468-A. The remand order of the court below, when combined with the risk of a possible second review proceeding, means an unspecified delay, perhaps into the 1970's. Even now the total amount of refunds due consumers is estimated to be nearly forty million dollars ($40,000,000). If another three or four-year delay occurs, this amount will be so great that consumers will be told that refunds are not possible because the producing industry will suffer irreparable damage.

Time is critical in this proceeding. Consumers, producers, and the Commission need a decision by this Court reviewing the first area rate decision. California maintains that the remand order of the court below is erroneous and obscure, and that it is unclear what the Commission must now do. The risk of a second review proceeding and another remand to the Commission is too great, and the questions of public policy are too important not to have a decision by this Court.

2. The Court Below Has Misconstrued This Court's Decisions in the Hope and Sierra Pacific Cases With Regard to Rate Making Under the Natural Gas Act

a. The Hope End Result Test Does Not Require That Area Revenues Equal the Allowable Area Cost of Service

The critical issue in this case is whether the Commission has complied with the legal requirements for rate making under the Natural Gas Act. The court below concluded that

the Commission failed to do so. Although the court recognized that "the Commission is not bound by any formula or method" in rate making under the Natural Gas Act, it concluded that the controlling standard for area rate making is the end result test set down in the *Hope* case. (App. A, pp. 400, 403, 412.) It rejected the Commission's determination that the end result test was satisfied by its finding that the rate order, when viewed in its entirety, established a fair relationship between the area rates prescribed by the Commission and the allowable cost of service for the area. The Commission's method involved consideration of composite cost data as a basic ingredient in area rate making, as well as other economic and policy factors, but it did not involve a specific finding that group revenues would balance group costs.[23] The lower court concluded that the Commission must, under the end result test, balance these costs and revenues. (App. A, pp. 411, 413.)

The position taken by the court below fully adopts the producers' contention that once composite cost-of-service data are utilized in area rate making, the Commission must proceed as it would in an individual utility company cost-of-service proceeding. (App. A, p. 428-29.) This position is erroneous because it interprets the *Hope* end result test to be extremely rigid and narrow, thereby denying any flexibility to the Commission at all, and it grossly misunderstands the area rate concept by viewing it as no different from individual company cost-of-service rate making. The end result

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23. It should be recognized that "group costs" as used herein refer to the Commission's cost-of-service determinations for new and old gas-well gas. These cost-of-service determinations were used as yardsticks for the pricing of other types of gas. They include allowances for exploration, which may or may not be expended for this purpose. Certainly the term "costs" does not refer to costs which must be recovered in order to avoid confiscation and consequent denial of due process.

test does not require that group revenues balance group costs; nowhere in the *Hope* case has this Court said that this test can be satisfied only by computing this particular equation. On the contrary, *Hope* affirmatively states that no single formula is required to be used in rate making under the Act. 320 U.S. 591, 602.

The essence of the end result test is whether the Commission's order *"viewed in its entirety"* meets the requirements of the Natural Gas Act. While the court below relied on *Second Phillips* for applying the end result test to area rate making, it failed to follow this Court's explicit description in that decision of what this test involves:

> "But to declare that a particular method of rate regulation is so sanctified as to make it highly unlikely that any other method could be sustained would be wholly out of keeping with this Court's consistent and clearly articulated approach to the question of the Commission's power to regulate rates. It has repeatedly been stated that no single method must be followed by the Commission in considering the justness and reasonableness of rates, *Federal Power Comm'n v. Natural Gas Pipeline Co.*, 315 U.S. 575; *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591; *Colorado Interstate Gas Co. v. Federal Power Comm'n*, 324 U.S. 581, and we reaffirm that principle today. As the Court said in *Hope*:
>
> > 'We held in *Federal Power Commission v. Natural Gas Pipeline Co., supra,* that the Commission was not bound to the use of any single formula or combination of formulae in determining rates. Its rate-making function, moreover, involves the making of 'pragmatic adjustments.' *Id.*, p. 586. *And when the Commission's order is challenged in the courts, the question is whether that order 'viewed in its entirety' meets the requirements of the Act. Id., p. 586. Under the statutory standard of 'just and reasonable' it is the result reached not the*

method employed which is controlling.' 320 U.S., at 602.

More specifically, the Court has never held that the individual company cost-of-service method is a *sine qua non* of natural gas rate regulation. Indeed the prudent investment, original cost, rate base method which we are now told is lawful, established, and effective is the very one the Court was asked to declare impermissible in the *Hope* case, less than 20 years ago." (373 U.S. 309; emphasis added.)

This passage clearly demonstrates that the Commission does not have to use one particular formula or equation, and that the end result test is made by viewing the Commission's order in its entirety to see if it is just and reasonable as required by the Act. The lower court has misunderstood the *Hope* case by transforming the flexible end result test into a rigid and narrow method consisting of no more than the revenues-must-equal-costs equation. It says, in effect, that only this equation satisfies the end result test, and this equation must show revenues equal costs or the rate order falls. This view is in direct conflict with *Hope* and the passage above from *Second Phillips* and the other cases cited therein.

Moreover, this rigid interpretation of the end result test is contradictory not only to the Commission's concept of area rate making but also to this Court's preliminary view of it in *Second Phillips*. In that case this Court stated that area rate making involves consideration of economic factors of the industry and not merely strict adherence to the revenue-cost equation. This Court quoted the statement by the Commission in Opinion No. 338 that it intended to set rates "based on 'the reasonable financial requirements of the industry' in each production area." (373 U.S. 294, 310.) This statement demonstrates that this Court under-

stood and approved of the Commission's intention to consider economic factors other than costs.[24]

Nevertheless, the court below emphasized that it rejected the Commission's "fair relationship" interpretation of the end result test because it was not told what economic factors "either require or permit departure from costs and revenues." (App. A, p. 429.) In taking this position, the lower court does not evaluate or even mention the various factors which the Commission said it did consider, such as: (1) that area rate making differs from individual company cost-of-service rate making in that it does not involve the costing of all gas, but instead, the costing of old gas-well gas as the yardstick to set the price for oil-well gas on a commodity value basis because this gas is a by-product of oil production and, as a result, its cost could not be accurately determined. (J.A. 574d, 614d-624d);[25] (2) that some 9.0 cents of the 14.5 cents price for flowing gas was partly based on non-cost factors with the purpose of meeting the producers' "revenue deficiency" argument (J.A. 1112d-1114d); (3) that the producers would receive additional revenues than merely those permitted by the Commission's rates because of certain contract provisions and because of the extraction of liquid hydrocarbons (J.A. 1112d-1115d); (4) that the Commission substantially reduced the amount of the downward price adjustments due to quality deviations (J.A. 1115d-

24. See also footnote 16, 373 U.S. 294, 310, where this Court announced that it did not interpret the decision of the Court of Appeals for the District of Columbia in *City of Detroit v. Federal Power Commission*, 230 F. 2d 810 (D.C. Cir. 1955), "to suggest that, in the view of that court, individual company cost of service is the method required to be used in independent natural gas producer rate regulation."

25. While the cost of oil-well gas could not be determined precisely, the Commission specifically found that its cost was substantially below the cost of old gas-well gas (J.A. 1112d).

1116d); and (5) that the Commission took into account that its rates should avoid abrupt departures from existing pricing patterns in order to avoid business dislocations (J.A. 573d-574d). At the very least, the court below should have given consideration to these factors in evaluating the Commission's decision. The lower court having failed to do so, the Commission is the victim of obscurity in that it has not been told why these factors are not sufficient to justify its finding of a fair relationship between revenues and costs.

Finally, the court below has refused to give the Commission any deference for its judgment and discretion as a federal administrative agency in possession of expertise in the matters under its jurisdiction. *Securities and Exchange Commission v. Chenery Corporation,* 332 U.S. 194, 207-8 (1947). It is clear that where rate making is involved some findings of regulatory bodies are proper without detailed explanations or even any supporting evidence. *Market Street Railway Company v. Railroad Commission,* 324 U.S. 548 (1945); 2 Davis, Administrative Law, 471-2 (1958). But the lower court has rejected, without any discussion, the various economic factors relied upon by the Commission in determining area rates.

b. The Rigid Interpretation by the Court Below Contradicts This Court's Holding in the Sierra Pacific Case

In requiring that group revenues balance group costs, the court below has disregarded this Court's decision in *Federal Power Commission v. Sierra Pacific Power Company,* 350 U.S. 348 (1956), which held that voluntarily made rates which are below the just and reasonable rate cannot be raised merely because they are unprofitable. A natural gas company may agree by contract to a rate affording less than a fair return, and, if it does so, it is not entitled

to relief by the Commission for its improvident bargain unless such relief is required by the public interest.[26] But the court below seems to suggest that the minimum rate be raised in order to make group revenues equate to group costs. Any such action would be directly contrary to the *Sierra Pacific* decision.

Unfortunately, the opinion of the court below is ambiguous on this point. While noting that "the producers are not entitled as a matter of right to collect contract rates that are higher than otherwise reasonable in order to offset other rates limited by contract to below maximum reasonable levels" and that "contract limitations are one of the facts of life for the natural-gas industry" (App. A, pp. 424), it expressed concern over the revenue deficiency resulting from these contract limitations, and it noted that in group procedures before the Interstate Commerce Commission "revenue from one source may balance that from another" (App. A, pp. 423-24). The lower court's discussion of this matter ends with the statement that "the controlling question is whether the proper revenue requirements of the area producers as a group can be satisfied with rates having the ceiling and the floor which the Commission has fixed" (App. A, p. 425). This language suggests that the minimum rate would be rejected or raised if the court concluded that the "proper revenue requirements" were not "satisfied." Significantly, the lower court concluded that it cannot answer this question because the revenue-cost equation has not been provided.

Whatever the lower court's opinion may mean with regard to this matter, there can be no doubt of the unlaw-

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26. 350 U.S. 348, 355. The Commission partly justified its minimum rate order as being in the public interest because its effect on consumers would be *de minimis*. No such finding is possible if the minimum rate is raised to produce 10 million dollars in order to balance the lower court's revenue-cost equation.

fulness of raising the minimum rate to or near the just and reasonable rate in order to balance group revenues and group costs. This view is contrary not only to the *Sierra Pacific* case, but also to *Federal Power Commission v. Tennessee Gas Transmission Company,* 371 U.S. 145 (1962), which held that losses in one zone of operations do not justify an illegal gain in another zone. If the court below is correct in viewing area rate making as only another instance of individual company cost-of-service rate making, then certainly it cannot ignore the *Sierra Pacific* and *Tennessee* cases by relieving the producers from their voluntarily made low contract rates.

3. It Is for the Commission to Determine the Proper Regulatory Method to Provide for the Impact of the Quality Deductions

The court below has rejected the Commission's method of providing for the impact of the quality adjustments by permitting a more than adequate rate of return. Contrary to the *Hope* case, the court has determined what method the Commission should use. The court has ordered the Commission to treat price deductions for deviations from pipeline quality gas as "an item of cost rather than an item of risk" which "should be directly reflected in the applicable base rates instead of hidden in a rate of return allowance" (App. A, p. 422-23).

By directing the Commission how to treat the impact of quality deviations, the lower court has again misconstrued the *Hope* case. Despite the fact that under *Hope* it is the end result, not the method used, which is the standard for judicial review of the Commission's rate orders, the court has disagreed with the Commission's views on the regulatory method to be followed and substituted its own theory and method. The Commission, as well as the Examiner in his initial decision, explained the compelling necessity for quality standards (J.A. 245d-246d;

645d-647d). Certainly the Commission has the expertise and discretion to view the quality problem as a risk. There can be no doubt that in exploring for natural gas there are at least two possibilities: (1) that no gas will be found, and (2) that the gas which is found may be poor in quality. Both these possibilities are unknown until drilling is completed. By holding that these price deductions for quality deviations be treated as an item of the cost of production, the court ignores the fact that there was no showing that low quality gas costs any more to produce than gas of pipeline quality, and the fact that the essential processing costs to bring it up to pipeline quality are borne by the pipeline purchasers. As the body possessing expertise in regulating this industry, the Commission is well within its legal powers to view this problem in the manner it deems best.

Moreover, the court refused to consider the question whether the 12 percent rate of return is adequate because, under the Commission's approach, it cannot "determine the amount of return with any degree of certainty." (App. A, p. 422.) The court justifies this refusal on the ground that the record failed to disclose the amount of the quality deductions, and therefore it was "impossible to determine whether the rate of return satisfies the *Bluefield* and *Hope* principles . . ."[27] (App. A, p. 423). In Opinion No. 468-A the Commission expressly found that while the record did not permit *exact* quantification of the impact of the quality deductions, there was adequate record support for the conclusion that the quality impact would be in the range of .7 to 1.5 cents per Mcf, reduced by additional revenue for plant liquids and the effect of the Btu adjustments (J.A. 1115d). Instead, the lower court erroneously stated

27. *Bluefield Water Works and Improvement Company v. Public Service Commission*, 262 U.S. 679 (1923).

that the only estimates of quality impact were based on the quality statements filed with the Commission pursuant to Opinion No. 468.[28] Since the quality impact was known and since the Commission found it to be reasonable, the court should have resolved the question of the adequacy of the rate of return which was deliberately made generous on this account.

4. The Remand Order of the Court Below Is Vague With Regard to the Special Relief and Quality Provisions

The decision of the court below is particularly obscure regarding the Commission's special relief provision and its quality standards in that it has left unclear what precisely the Commission must do upon remand.

Concerning the special relief provision, the court below seems to conclude that the Commission intended to grant relief only from confiscation. (App. A, p. 419.) Such a conclusion is clearly erroneous. The Commission did not limit the basis for invoking the special relief procedure to claims of confiscation; it specifically stated that "there may be other circumstances where a producer as a matter of law or in the public interest would be entitled to some relief" (J.A. 658d). Obviously when the Commission has only begun the task of establishing a new concept such as area rate making, it cannot now foresee all possible relief situations.

The relief provision was designed to provide notice that relief would be available. For practical reasons, the Commission did not attempt to foresee all the possible factual situations justifying special relief, nor did it spell out in detail what the relief would be. These specifics obviously

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28. The court is inconsistent here. It did rely on the Commission's estimate in order to justify its decision that quality deductions should be treated as a cost item, but it did not use the estimate in considering the adequacy of the rate of return, saying that the record failed to disclose the amount of the deductions. (App. A, pp. 423, 422.)

could be provided when the time for such relief arose. The court below, however, characterized this provision as "inadequate" and said that an adequate relief provision would "contain guidelines which if followed by an aggrieved producer will permit it to be heard promptly and to have a stay of the general rate order until its claim for exemption is decided." (App. A, p. 419.) In addition, the lower court seems to say that individual costs should be the basis for relief. (App. A, p. 419.) This position would mean a return to individual cost of service.

In directing that each producer be entitled to a stay from the Commission's rate order, the lower court provides the means to undermine area rate making through numerous stays pending relief. The Commission could be deluged with hundreds of petitions for relief. No such right to a stay was required by this Court in the *New England Divisions* case, 261 U.S. 184 (1923), in which the Interstate Commerce Commission's rate order became effective immediately, subject to later adjustment if a proper showing was made. As in that case, there is no reason for an automatic stay from area rates; the general rule should prevail that stays will be granted only upon a showing of irreparable injury to the producer concerned. The mere possibility that a producer is entitled to special relief from area rates does not justify the continuance of collecting rates which have been held to be too high. *Federal Power Commission v. Tennessee Gas Transmission Company*, 371 U.S. 145, 151-2, 154 (1962); *United Gas Improvement Company v. Callery Properties, Inc.*, 382 U.S. 223 (1965).

With regard to quality standards, the lower court is even more obscure. It specifically required explanation why the Commission provided the "Btu gap" in its quality standard for Btu content. (App. A, p. 421.) But it failed to approve or disapprove the other quality standards. It merely com-

mented that it would not resolve *at this time* the producers' contention that procedural due process was violated because of lack of notice on the matter of quality standards. Such language leaves the Commission in a quandary. Is it supposed to reopen all the quality standards for further hearings and redetermination, or should it just explain at greater length its reasons for the Btu gap. If it fails to reopen all the quality standards for further hearings, the Commission risks a second remand on the notice question. The effect of the lower court's decision is to reverse the Commission on all its quality standards without giving any reasons.

CONCLUSION

Petitioners respectfully request the opportunity to present these questions to the Court more fully. They are important questions of public law. They are questions affecting millions of citizens and involving millions of dollars. Their resolution will have far-reaching effect.

Petitioners respectfully submit that this petition for a writ of certiorari to the United States Court of Appeals for the Tenth Circuit should be granted.

Respectfully submitted,

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Dated: April 17, 1967

APPENDIX

APR 19 1967
JOHN F. DAVIS, CLERK

IN THE

Supreme Court of the United States

October Term, 1966

No. ...[redacted]100

PEOPLE OF THE STATE OF CALIFORNIA and PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA,
Petitioners,

vs.

SKELLY OIL COMPANY,
PHILLIPS PETROLEUM COMPANY,
WARREN PETROLEUM CORPORATION,
MOBIL OIL CORPORATION (formerly Socony Mobil Oil Company, Inc.),
PAN AMERICAN PETROLEUM CORPORATION,
NORTHERN NATURAL GAS PRODUCING COMPANY,

[*Continued on Inside Cover*]

APPENDICES TO PETITION FOR WRIT OF CERTIORARI

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San Francisco, California 94102,

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Jeffries Banknote Company, Los Angeles — MA 7-9514

[*Continued From Cover*]

STANDARD OIL COMPANY OF TEXAS, a Division of Chevron Oil Company,

TEXACO INC.,

HUNT OIL COMPANY jointly with
H. L. Hunt,
Lamar Hunt,
N. B. Hunt,
W. H. Hunt,
Secure Trusts,
Caroline and Loyd B. Sands,
Caroline Hunt Trust Estate,
Lyda Hunt-Caroline Trusts,
Lyda Hunt-Bunker Trusts,
Lyda Hunt-Lamar Trusts,
Lyda Hunt-Herbert Trusts,
Lyda Hunt-Margaret Trusts
(formerly Estate of Lyda Bunker Hunt, Deceased),
Hunt Industries
(formerly Estate of Lyda Bunker Hunt, Deceased), and
Placid Oil Company,

HUMBLE OIL & REFINING COMPANY,

SHELL OIL COMPANY,

THE ATLANTIC RICHFIELD COMPANY (formerly The Atlantic Refining Company), jointly with
Dorchester Gas Producing Company,
Southland Royalty Company, and
Westates Petroleum Company,

CONTINENTAL OIL COMPANY jointly with
Sunray DX Oil Company,
Sinclair Oil & Gas Company,
Cabot Corporation,
Sohio Petroleum Company,
Joseph E. Seagram & Sons, Inc.,
Joseph E. Seagram & Sons dba
Texas Pacific Oil Company,
Gulf Oil Corporation,
Murphy Oil Corporation,
The Nueces Company,
Samedan Oil Corporation,
Cities Service Oil Company
(formerly Cities Service Petroleum Corporation),
Cities Service Production Company
(now merged with Cities Service Oil Company),

[*Continued From Inside Cover*]

Columbian Fuel Corporation,
Amerada Petroleum Corporation,
Union Oil Company of California and as successor to The Pure Oil Company,
Tidewater Oil Company,
Reef Corporation, and
William A. & Edward R. Hudson, Joint Operators,

MARATHON OIL COMPANY,

SUN OIL COMPANY,

INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA,

THE BRITISH-AMERICAN OIL PRODUCING COMPANY,

UNION TEXAS PETROLEUM, a Division of Allied Chemical Corporation,

MIDHURST OIL CORPORATION,

THE SUPERIOR OIL COMPANY,

PERRY R. BASS jointly with
Panther City Investment Co.,
Bass Bros. Enterprise, Inc.,
Perry R. Bass, Incorporated, and
Richardson Oils, Inc.,

COLUMBIAN CARBON COMPANY, jointly with Coltexo Corporation,

THE STATE OF TEXAS,

BIG CHIEF DRILLING COMPANY jointly with
King-Stevenson Oil Co., Inc., and
Service Drilling Company,

TEXAS INDEPENDENT PRODUCERS & ROYALTY OWNERS ASSOCIATION jointly with
West Central Texas Oil and Gas Association,

STATE OF NEW MEXICO,

GULF OIL CORPORATION, and
J. C. BARNES, *et al.*,

Respondents.

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APPENDIX A

277,567

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Before Commissioners:

Joseph C. Swidler, Chairman; Lawrence J. O'Connor, Jr.; Charles R. Ross; David S. Black; and Carl E. Bagge

	Docket Nos.
Area Rate Proceeding	AR61-1
Claude E. Aikman, *et al.*	G-18466, *et al.*
North Central Oil Corporation (Operator), *et al.*	C160-435, *et al.*

OPINION NO. 468

OPINION AND ORDER DETERMINING JUST AND REASONABLE RATES FOR NATURAL GAS PRODUCERS IN THE PERMIAN BASIN

(Issued August 5, 1965)

INTRODUCTION

SWIDLER, Chairman:

This is the first area proceeding to determine just and reasonable rates for natural gas producers. It is the culmination of an effort initiated more than four and a half years ago, and which has been carried forward with the greatest sense of urgency on the part of all concerned. The area is the Permian Basin, one of the nation's great oil and gas provinces, comprising the counties of Chaves, Eddy and Lea, New Mexico, and Texas Railroad Commission Districts No. 7-C and No. 8.

Pursuant to Section 5 of the Natural Gas Act we here establish the future rates for jurisdictional sales of gas by producers in the area.[1] Also consolidated in this area proceeding are a large number of increased rate filings suspended under Section 4 of the Act and a limited number of applications for certificates of public convenience and necessity pursuant to Section 7 which are disposed of in a separate order issued this date.

The Commission initiated the proceeding by order of December 23, 1960 (24 FPC 1121). Prehearing conferences were held in Midland, Texas, beginning March 6, 1961, and in Washington on April 27, 1961. Forty-seven petitions to intervene were granted. The number of parties in the proceeding total 384, including 336 gas producers who are respondents.

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[1] The respondents are listed in Appendix A to this opinion.

The Commission prescribed questionnaires for the major producer respondents to obtain information with respect to Permian Basin and nationwide cost and operating experience. 26 FPC 247, 514, 531 (1961). A special form was prescribed for the small producers. 27 FPC 20 (1962). (The dividing line between major and small producers was determined by the level of nationwide jurisdictional sales, 10 million Mcf in calendar year 1960). A significant early ruling in this proceeding was the Commission's order of May 14, 1962, holding that individual company cost-of-service evidence would not be received in evidence but that composite cost studies would be admissible. 27 FPC 943 (1962).

The hearings extended over a period of almost two years beginning on October 11, 1961, and closing on September 12, 1963. The examiner rendered his decision on September 17, 1964.

Fourteen individual and joint briefs on exceptions were filed on behalf of 111 respondents and numerous other interested persons, not parties, who joined with them. Most of the producers adopted the briefs on exceptions of Continental Oil Company (Major Producer Group).[2] Separate briefs were filed by the Com-

[2] Respondents filing independent or supplemental briefs on exceptions included Amerada Petroleum Corporation (Amerada); Humble Oil and Refining Company (Humble); Hunt Oil Company, *et al.* (Hunt); Perry R. Bass (Operator), *et al.* (Bass); Phillips Petroleum Company (Phillips); Placid Oil Company (Placid); Standard Oil Company of Texas, a Division of California Oil Company (Standard); Sun Oil Company (Sun); Superior Oil Company (Superior); and Warren Petroleum Corporation (Warren).

mission staff, by the numerous interveners and as *amici curiae* by several groups with a substantial interest in the general problem.[3]

Oral argument lasting three days was held beginning February 8, 1965, and the proceedings are now before us for decision.

SUMMARY OF EXAMINER'S DECISION

We acknowledge at the outset our indebtedness to Examiner Wenner for his penetrating analysis of the basic economics of the industry and his constructive proposals for a pricing system in harmony with the realities of the industry and the Commission's responsibilities under the Natural Gas Act. We must acknowledge also the helpful and constructive role of the parties to the proceeding. The cooperation of the respondents and the interveners with the Commission has been instrumental in achieving what the examiner has described as a breakthrough in reaching a workable method of producer regulation.

[3] Interveners filing briefs on exceptions included Northern Natural Gas Company (Northern); King-Stevenson Oil Company, Inc., *et al.* (Oklahoma Interveners); the State of California and the Public Utilities Commission of California (jointly referred to as Cal-PUC); a group of California distributors (California Distributors); the City and County of San Francisco (San Francisco); the City of San Diego (San Diego); the State of Texas jointly with Texas Independent Producers and Royalty Owners and West Central Texas Oil and Gas Association (Texas-TIPRO-WCTOGA); and the Independent Petroleum Association of America (IPAA). Briefs on exceptions as *amici curiae* were filed by Philadelphia Electric Company (Philadelphia); Associated Gas Distributors (AGD) (a group of approximately seventy major distributors) and the Oklahoma Independent Petroleum Association (OIPA).

The examiner's decision would establish ceiling prices to apply, with certain exceptions, to all the sales being considered in this proceeding. These proposed ceilings were, in the case of rate schedules filed with this Commission on or after December 23, 1960, 16.75 cents per Mfc for gas-well gas, 15 cents per Mcf for residue gas, and 11 cents per Mcf for oil-well gas. In the case of rate schedules filed before December 23, 1960, the proposed ceilings were 13.5 cents per Mcf for gas-well gas and residue gas and 10 cents per Mcf for casinghead gas. The presiding examiner found, however, that the rates of producer-respondents making jurisdictional sales of less than 10,000,000 Mcf annually were just and reasonable and did not apply the proposed ceilings to any such respondents. Operators of processing plants, even if selling less than 10,000,000 Mcf annually, would have their rates limited by the proposed ceilings.

In the case of Section 4(e) proceedings consolidated herein, the examiner would order certain refunds which were to be computed for separate years and categories of gas on the basis of whether the industry had realized more than the proper revenue as well as on the basis of the individual rates collected. Deficiences in one category would be used to offset excessive revenues in

other categories each year. The presiding examiner further stated that since the record does not contain information needed to determine the actual or proper revenue for years other than 1960, for such years the parties

within 90 days of the initial decision should submit draft orders with requests for information and with specific proposals regarding refunds.

The presiding examiner declared most favored-nation clauses and spiral escalation clauses in existing contracts to be inoperative and of no legal effect, and would allow no future change in rate resulting from any such clause to take effect. He fixed a minimum price of 9 cents per Mcf for residue and gas-well gas and 7 cents per Mcf for casinghead gas, and would allow rate increases to these levels to be filed with the consent of the buyer.

THE NATURAL GAS INDUSTRY AND ITS ACTIVITIES IN THE PERMIAN BASIN

The major known deposits of natural gas in the United States are located primarily in the States of Texas, Louisiana, Oklahoma, New Mexico, and Kansas. In addition, there are substantial reserves in the offshore area of Louisiana and Texas. More than 70 percent of all the natural gas produced for marketing in the United States is sold in interstate commerce subject to the jurisdiction of the Commission. The Permian Basin alone accounts for about 11 percent of all the gas moving into the interstate market.

Natural gas and crude oil are both hydrocarbons, and they are often found in common reservoirs. As a result gas and oil production are interrelated. Our responsibility is confined to regulating the sales of natural gas. In his opinion (p. 23) the examiner classified natural gas as "oil well gas" or "gas well gas", depending upon

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the conditions of production. He used the term "residue gas" to describe oil-well gas or gas-well gas after it has been processed and the liquids removed.

277,571

— 5 —

The natural gas industry is divided into three distinct segments. First there are the producers. Jurisdiction under the Natural Gas Act attaches when the gas is sold for resale in interstate commerce. The intermediate segment of the industry consists of the interstate pipeline companies which transmit the gas from the producing fields through large diameter pipelines as much as a thousand miles or more to centers of distribution throughout the nation. The third segment of the industry comprises the distributors of the gas in thousands of communities throughout the nation who are under state or local regulation exclusively, but who rely on this Commission to regulate the price at which they purchase gas at wholesale from the interstate pipelines. It should be noted that there is some overlapping in these categories. Some pipeline companies produce a share of their own natural gas and sell gas to other pipelines; other engage in distribution operations. Also, some producers perform gathering or transportation services and some distributors engage in production and transmission activities.

The Permian Basin is a major geological formation underlying much of western Texas and southeastern New Mexico. It is rich in oil and gas deposits, and is one of

the major hydrocarbon producing areas in the Western Hemisphere.

About two-thirds of the gas produced in the Permian Basin is oil-well gas, that is, gas produced in conjunction with oil. By contrast, oil-well gas represents only about one-third of the total gas production in the continental United States. Oil-well gas is limited as to the hours of availability in a month since it is governed by the allowable oil production, which is subject to state regulation. The gas must be produced as the oil is produced, and it is not produced at any other time. It is produced on such a basis as will maximize the production of oil, for which it is the lifting agent. In

these respects it contrasts unfavorably with gas-well gas, which while subject to state prorationing authority on a field basis, can be produced on a demand schedule. Oil-well gas is also produced at lower pressures than those common to gas-well gas. Production at less than 50 pounds pressure is not unusual in the case of oil-well gas. Since pipelines require pressures approaching one thousand pounds, low-pressure gas must be compressed before it can be taken into a pipeline stream. Processing of such gas will include one, two, three or more stages of compression.

In the Permian Basin, most oil-well gas is "sour" gas before processing.[4] Some of the gas from the Permian Basin also has an unusually high carbon dioxide content, ranging in some instances as high as 50 percent. Carbon dioxide is non-flammable and is presently useless to the petrochemical industry. When present in significant quantities it must be removed, entailing both processing costs and reduction in the volume of gas which remains for use.

Historically, prices for gas in the Permian Basin have been lower than prices in most other areas. For many years oil-well gas was vented or flared, because there was no market for it. Three interstate pipelines, however, now make substantial purchases of gas in this area, and venting or flaring has been reduced to very low levels. El Paso Natural Gas Company (El Paso) began purchasing Permian Basin gas in 1945 for interstate transmission in connection with construction of the first natural gas pipeline from Texas to California. It was the sole interstate purchaser until 1954. In that year Northern Natural Gas Company (Northern) made its first purchase in the Permian Basin through Permian Basin Pipeline Company. In 1958 Transwestern Pipeline Company (Transwestern) began its purchases in the Permian Basin to supply the second pipeline from that area to California.

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[4] "Sour" gas is considered to be gas containing 10 or more grains of hydrogen sulphide or 200 or more grains of total sulphur per Mcf. The sulphur content of Permian Basin oil-well gas is generally higher than that of gas from any other area in the United States.

In 1961 El Paso purchased 73 percent of the Permian gas moving in interstate commerce; Northern accounted for 18 percent, and Transwestern for 9 percent. It is estimated that 85 percent of the gas moving in interstate commerce from the Permian Basin goes to California, an area of rapidly expanding demand by both industrial and residential consumers. The gas-producing wells in the Permian Basin, therefore, are some 900 to 1,300 miles from the principal points of use for the gas.

HISTORY OF THE DEVELOPMENT OF THE AREA APPROACH TO PRODUCER REGULATION

The Federal Power Commission's regulation of the rates of electric utilities and natural gas pipeline companies under the Federal Power Act and Natural Gas Act had uniformly been conducted on an individual cost-of-service basis at the time of the Supreme Court's *Phillips* decision on June 7, 1954[5] which held that the Commission had jurisdiction over the regulation of well-head gas prices, a jurisdiction the Commission had theretofore questioned. Faced with the novel problem of regulating thousands of gas producers, the Commission's first guarded attempts at producer regulation were on an individual company basis.[6] A few of the first rate in-

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[5] *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672 (1954).

[6] Ross, W. W., "The Area Rate Proceedings," 18 S. W. L. J. 165, 170 (1964); note, "F.P.C. Regulation of Independent Producers of Natural Gas," 75 Harv. L. Rev. 549 (1962).

The fact that the increase in condensate products has outstripped the increase in gas-well gas production reflects the richer content of liquids in the new gas-well gas which is being discovered and the improved separation techniques developed by the industry. The examiner by basing his credit exclusively on the liquid to gas ratio in current production has not taken into account this trend in condensate production. Since we are here concerned with a ceiling price to apply to new gas-well gas, the liquid credit we allow must reflect current and expected experience. We believe that a figure based upon the respondents' responses to the Commission's questionnaire is more nearly representative of current trends. Witness Park determined a gross credit of 3.71 but as was explained with regard to production operating expenses (*supra*, page 54) we agree with the examiner and Witness Roseman that the questionnaire data from which this figure was derived by Witness Park was not fully representative of industrywide production. The questionnaire data reflects a larger production of condensate on a unit basis than do the nationwide statistics. Accordingly, in our judgment, the 3.71 cents per Mcf gross liquid credit should be adjusted downward to reflect this distortion. We believe that taking all facts into consideration the proper gross liquid credit should be 3.50 cents per Mcf. This credit is based upon production which is well within the range of published statistics for 1960 and is in line with the trend in later years toward increased realization of condensate per Mcf of gas.

The gross figure of 3.50 cents after deduction of production taxes and royalties leaves a net liquid credit of 2.90 cents, not including plant liquids, which we here adopt.

In addition to liquids extracted at the well, gas-well gas is also processed at stripping plants. Producers usually share in the revenues from these plant liquids on a percentage basis. Witness Roseman testified that if the producers receive only 20 percent of the liquid revenues it would amount to 0.4 cent per Mcf of gas-well gas produced. The California Distributors and Texaco, who sponsored witness Park, stipulated that for purposes of this case a credit for plant liquids in the range of 0.1 cent to 0.2 cent per Mcf of gas-well gas produced could be used. In light of Witness Roseman's analysis and the trend of richer liquid content which the record reveals we shall adopt the examiner's conclusion that the upper range of the stipulation, 0.2 cent per Mcf, should be accepted as an appropriate plant liquid credit.

The addition of 0.20 cent per Mcf to the 2.90 cents per Mcf net liquid credit gives a total liquid credit of 3.10 cents per Mcf.

REGULATORY EXPENSE

Neither Witness Roseman, for the California Distributors, nor Witness Park, for the Major Producers Group, included in the computation of costs any amount of regu-

latory expense. The presiding examiner, however, included in his computation an item of .14 cent per Mcf for regulatory expense, based on data derived from answer to the questionnaire. Since it appears to be a reasonable estimate and no participant disputes its inclusion, it will be accepted.

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DEPLETION, DEPRECIATION, AND AMORTIZATION OF PRODUCTION AND INVESTMENT COSTS

Production investment costs include successful well costs, lease acquisition costs and cost of other production facilities. These items were capitalized by the presiding examiner, and we agree. The total of these items will establish the rate base on which a return must be allowed. The amount of the rate base itself must be recovered by the producers by charges for depletion, depreciation and amortization over the period of the economic life of the investment. The procedure we use is to convert DD&A to an Mcf basis and to add an element for return on the production investment per Mcf. We shall discuss separately each item involved in the calculation.

Successful Well Costs

The examiner found that successful well costs amounted to 2.88 cents per Mcf of gas found. He determined this amount by dividing the cost per foot of

successful wells drilled in 1960 by the average of gas reserves added per foot of drilling in a year. The drilling cost per foot was derived from data in the U. S. Bureau of Census, Census of Mineral Industries for 1958, adjusted to 1960 on the basis of the questionnaire data. The total reserves added were derived from the AGA proven reserve statistics.[27]

The Major Producer Group first argues that the Joint Association Survey (JAS)[28] cost per foot of well drilling should be used in place of the 1958 Census data as trended to 1960. In the alternative, they urge that if the 1958 Census cost is used, this cost should not be adjusted downward on the basis of the questionnaire data to arrive at the 1960 cost. They conclude that the successful well drilling cost should be computed at 3.10 cents per Mcf of gas reserves added, rather than 2.88 cents as computed by the presiding examiner.

We agree with the presiding examiner that the JAS statistics should not be used to decide this issue. The presiding examiner has pointed out that the companies included in the JAS were not selected on a random basis, and that filling out and returning the JAS questionnaire was voluntary. The results thus reflect a considerable

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[27] Identified in this proceeding as Bureau of Mines *Minerals Yearbook*, Vol. II (which is a reprint of the AGA data). The footage used with this data was obtained from *World Oil* magazine.

[28] The JAS is a survey by three industry trade groups and is based on a questionnaire mailed by these groups to all their member companies.

amount of self-selection. Due to the method of selection there is no assurance that the sample is characteristic of the industry as a whole and it should not be used in preference to the 1958 Census, even though cost based upon the 1958 Census was adjusted by trending to determine the comparable 1960 cost.

In our discussion of dry-hole costs we have already dealt with the question whether cost derived from the 1958 Census may properly be trended on the basis of questionnaire data to determine comparable 1960 costs, and affirmed the examiner on this point. We believe it is not only appropriate but necessary to make the same adjustment in this connection. The exceptions in this regard will therefore be denied.

Lease Acquisition Costs

Witness Roseman, on behalf of California Distributors, computed lease acquisition costs at 0.76 cent per Mcf for gas found. In common with all other witnesses on this subject, he determined the cost per Mcf of lease acquisitions on the basis that such cost is directly related to successful well drilling cost. He found that the appropriate figure was 26.4 percent on the basis of data collected in a survey by the Chase Manhattan Bank and data contained in the 1958 Census.

The presiding examiner accepted Roseman's computation of 0.76 cent per Mcf. The Major Producer Group

excepts to this finding, and contends that Witness Park's computation of 1.15 cents per Mcf should be used. Park computed his figure on the basis that lease acquisition cost is 40 percent of successful well cost per Mcf.

We agree with and adopt the presiding examiner's analysis of this question set forth in Appendix B to the initial decision, pages 80-83. The adopted portion, together with an additional analysis reinforcing our conclusion here, is set forth in Appendix B to this opinion.

Cost of Other Production Facilities

The examiner approved 0.31 cent per Mcf for this item which includes lease equipment, related lease facilities and apportioned overhead investment. The 0.31 cent figure is supported by the testimony of Witnesses Roseman and Park, but for different reasons. Witness Park's recommendation was an integral part of a broader presentation which we have not accepted and for that reason we rely on the testimony of Witness Roseman. In substance, Witness Roseman's testimony is that the respondent's gross investment in these items approximates 8½ percent of the gross investment in leases and wells attributable to non-associated gas, and that a comparable percentage of the previously determined lease and well costs should be allowed for these items. We find the amount to be reasonable and we shall affirm the examiner's finding on this point.

Allowance for Growth in Investment

The Major Producer Group contends that in his computation of production investment costs the presiding

examiner should have included an allowance to reflect future increases in investment. We believe

the examiner correctly excluded such an adjustment. Production investment costs are capitalized and recouped, with a return realized from the sale of gas over the period of the life of the investment. This investment is stated in terms of an amount per Mcf of gas found. While the total investment may grow, there is nothing in this record to support a conclusion that there will be an increase in the amount invested per Mcf of gas found. Accordingly, we believe there is no basis for any additional amount as an allowance for growth in production investment costs.

Period of Recovery of Investment

A return must be allowed upon the investment for the average period of recoupment. Having determined the total production investment cost to be 3.95 cents per Mcf, the presiding examiner then estimated that the average period required for return of each dollar of that investment will be 10 years after the resulting gas begins to flow. He reached this conclusion by assuming that the gas will be totally depleted in 20 years, the normal life of a contract, and that the depletion will take place in an equal amount each year. The Major Producer Group and The Superior Oil Company contend that the true

period of depletion is at least 22 years, and that this period rather than 20 years should be the basis of calculation.

These respondents are correct in pointing out that the period of well depletion is somewhat longer than 20 years. More than offsetting, however, is the fact that wells are not depleted uniformly over their producing life. They produce a greater output of gas and condensate during the first years of depletion. Production usually begins to decline some 7 to 12 years after the well begins to flow until, during the last years of depletion, the well is producing only a fraction of its flow in earlier years. While exact figures are not available, it appears that the additional years of minimal production, not included in the examiner's computation, are more than offset by his computing depletion at an even rate rather than taking into account the higher production in early years and the greatly lowered production at the end of the period. Accordingly, the exceptions on this point will be denied.

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Lag

Some of the production investment costs must be made in advance of the time that gas begins to flow. Lease acquisitions are often made a substantial time in advance. Expenses for successful wells must be incurred before any gas can be produced. To allow for this lag between investment and first realization of revenue from sale of the re-

sulting gas, the presiding examiner allowed 1 year of so-called "lag time" in addition to the 10-year period in which the average dollar of investment will be recouped after production begins.

The California Distributors urge that no lag period be included. They contend that the investment of funds before gas begins to flow is more than offset by the fact that some of the investment is not made until after gas has been in production for some time. They refer to this as "negative lag."

The Major Producer Group, on the other hand, contends that the lag should be from 3 to 5 years, and that the 1-year period allowed by the examiner is insufficient.

While it is generally conceded that a time gap does exist between the outlays for some productive investment and the initial receipt of income, the evidence in the record is general and vague insofar as it concerns a specific time period. Moreover, this general testimony is offset to a certain extent by the evidence of investment which does not take place until gas has been in production and evidence that some items will be used for only part of the time in which a return will be allowed. There is no precise computation of the average amount of expenditures involved in either the lag or the "negative lag," or of the amounts of time by which these expenditures precede or follow the date when gas begins to flow.

Geological and geophysical expenses and exploratory overhead, both of which may be expended several years before a well begins to produce, are not ordinarily ac-

counted for as part of production investment costs. They are part of exploratory and development costs which are

treated as expenses by the producers in the year in which they are incurred. Successful well drilling costs are approximately 73 percent of the production investment costs. These would ordinarily be incurred within the one year lag before gas begins to flow which the examiner has allowed. Lease acquisition costs may occur earlier, but these are little more than 19 percent of the total production investment costs. The cost of other production facilities, which is approximately 8 percent of the total production investment cost, as here determined, would be incurred largely within the one-year lag period.

Taking into consideration the evidence of both the positive and negative lag, we believe that the presiding examiner's determination on this point should be upheld.

RETURN ALLOWANCE

Rate of Return

Respondents urge the adoption of a rate of return in the range of 16-18 percent on average net investment. In support, they refer to returns previously allowed in producer and pipeline litigation and to the traditional and current earnings experience of numerous industrial and utility categories. Respondents' principal argument is that the risks inherent in exploration are voluntarily in-

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curred and extraordinary and they must be recompensed in the rate-making process. They also argue that the discounted cash-flow analysis is the keystone to the producer return issue. The producers also stress the time lag between investment of funds and receipt of income.

Staff, joined by the California interests, presses for a 9½ percent return on average net investment which translates into 10½ percent on common equity. Staff offered extensive testimony which focuses heavily on the earnings experience of integrated producers, who supply the bulk of the natural gas production. Staff supports its reliance on the experience of the integrated producers partly by claiming there is no proof that their non-production departments are less risky than their production departments. Staff recognized the geological

risks inherent in exploration but considers them to a degree offset because of the producers' alleged ability to avoid income taxes, their low-debt capital structure, and the opportunity, implicit in group regulation, for low-cost producers to achieve higher than average returns. For these reasons, Staff concludes that a return must be set in this proceeding which is somewhat lower than that which would be deemed appropriate in the context of individual regulation.

In determining an appropriate rate of return, the Commission must operate within long-accepted judicial

guidelines. Many of them, although established in the context of individual company regulation, apply with equal validity to the *en masse* regulation we have adopted herein. Simply stated, the courts have consistently held that the return must be sufficient to attract new capital, be in line with that earned by comparable industries, *e.g.*, *F.P.C.* v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944); *Bluefield Water Works and Improvement Co.* v. *F.P.C.*, 262 U.S. 679 (1923), and most significantly, be determined, not through the automatic application of formulae, but through informed judgment taking into account all relevant facts, *e.g.*, *State Corp. Commission of Kansas* v. *F.P.C.*, 206 F.2d 690 (CA8 1953), cert. denied, 346 U.S. 922 (1954); *Washington Gas Light Co.* v. *Baker*, 188 F.2d 11 (CADC 1950), cert. denied, 340 U.S. 952 (1951).

As a starting point in our analysis, we turn to the financial requirements and experience of a sector of the gas industry with which years of regulation have made us familiar, the natural gas pipelines. The transmission sector is an immediate adjunct of production, and the two have evolved contemporaneously. An examination of recent transmission company rate proceedings indicates that representative companies

are currently being allowed returns on net investment in the 6.0-6.5 percent range, with the preponderance between 6.25-6.5 percent. While we have recently been em-

phasizing the overall return, it is instructive that a 6.25-6.5 percent return on transmission net investment translates, considering current capitalization patterns, into a yield on equity of from 10.0 to 12.0 percent. Although this yield is by no means dispositive of the issue before us, it places the issue of an appropriate rate of return for gas production in a more meaningful context, especially in view of the fact that producers generally are 85 percent equity companies. In addition, production operations inherently involve a greater degree of risk than the transportation of gas.

The difference in the degree of risk is highlighted by the fact that the construction and operation of transmission lines are authorized only upon the issuance of certificates of public convenience and necessity, and these, in turn, require a showing of economic feasibility. *Northern Natural Gas Co.*, 28 FPC 1155 (1962). By contrast a producer who is exploring for new gas is relying largely on the law of averages, especially under the area rate approach.

Transmission companies generally have assured sources of supply, traditionally under at least twenty-year contracts. They are generally able to shift to their purchasers the burden of their costs, and they have a minimal labor problem. Considering these factors, together with the projected continuation of a 3.5 percent growth in consumer demand, the 6.25-6.5 percent overall return and the 10 to 12 percent yield on equity for pipelines can be considered as applying to a relatively safe investment, at least by comparison with gas production.

In comparing the allowable returns on production with the returns previously allowed in transmission proceedings legal precedent and financial requirements dictate that if unusual risks are inherent in production, a greater return should be allowed on investments therein in the absence of record evidence to support a different conclusion. See, *e.g.*, *F.P.C.* v. *Hope Natural Gas Co., supra; F.P.C.* v. *Natural Gas Pipeline Co.*, 315 U.S. 575 (1942); *Bluefield Water Works and Improvement Co.* v. *F.P.C., supra; Wilcox* v. *Consolidated Gas Co.*, 212 U.S. 19 (1909). It is beyond question that the business of exploring for natural gas and, to a lesser extent, its production, is fraught with uncertainties foreign to its transmission. Justice Jackson pointedly expressed this fact in his oft-quoted dissenting statement in the *Hope* case, and the Commission has repeatedly recognized it. Thus, we said in *Phillips*:

> It is clear that the risks of this business [exploration and development] are greater than those of an electric utility or natural gas pipeline. 24 FPC at 572.

We have also noted the special risks involved in production operations:

> The producer must invest his funds prior to ascertaining whether he will have anything to sell or whether, if he does, he will have an adequate market. *Id.* at 543.

And later in *CATCO:*

> We are fully cognizant of the risks of drilling for gas and the need to encourage continued exploration and production. 27 FPC at 106.

And still later in *Southern Natural Gas Co.*, 29 FPC 323, 336 (1963):

> It is well recognized that a series of dry holes or even a single dry hole may bankrupt an independent producer, and it is equally well recognized that an independent producer who has the misfortune to discover high-cost gas may very easily find it impossible to dispose of such gas at a price which returns more than a small fraction of his costs of discovery and development.

The principal uncertainty lies in finding gas in commercial quantities, and is emphasized by the record evidence that producers, while seemingly able to a degree to direct their searches for particular hydrocarbons, have no assurance that any hydrocarbon will be found. The risk of a dry hole — or noncommercial well — is one that has characterized the production activity since its inception. That the risk is not merely theoretical is borne out by the questionnaire data compiled in Staff exhibit 142 which reveals that Permian respondents in 1960 spent approximately $212,342,000 on geological and

geophysical expenses, $114,284,000 on lease rentals and $271,576,000 on dry holes. While it is true that in the aggregate we allow these costs as an operating expense, the uncertainty whether productivity will meet the industry average nevertheless remains as a risk for each individual producer and it must be recognized in the rate-making process.

There is another risk in the production operations which our allowance for a rate of return in this proceeding must reflect — the risk of finding gas of less than pipeline quality. The record reveals that the greater percentage of the gas in the Permian Basin does not fully meet the pipeline quality standards prescribed herein. The details respecting quality adjustments are discussed *infra* at pages 94-103. While we have provided upward adjustments for new gas-well gas with above average Btu content, nevertheless there remains the risk that any gas found can be sold only at an adjusted ceiling price which involves a substantial discount from the ceiling prices for gas of pipeline quality prescribed herein. Such risk is a special factor that must be considered in establishing the rate of return for the Permian Basin.

Agreeing that production operations involve risks which must be recognized in our allowance for rate of return, yet we conclude that the risks are not as great as the producers claim. The producers' case for a 16-18

percent rate of return ignores the fact that there is a degree of predictability to production operations as evidenced by the fact that the industry as a whole has maintained over extended periods a consistent record of new discoveries and added reserves. The producers statistical support for a 16 to 18 percent return rests on data that contain conspicuous infirmities. As pointed out by the examiner, Witness Morton's statistical presentation contains only one instance of an 18 percent rate of return on capitalization. We affirm the examiner's conclusion that Morton's sample is unrepresentative.

The return producers seek is greatly in excess of the recent earnings experience of even the nonintegrated producers. It is three-fold the return allowed on transmission investments and it would produce a yield on common equity of approximately 20 percent. Such a return is neither typical nor necessary, and must be rejected.

We have already discussed the "true yield" method for determining capital cost which expresses the discount rate equating the value of a stream of future revenue with the cost of the initial investment generating that stream. It is employed herein by the producers to demonstrate the earnings rate disparity between it and the conventional method which allows a return on net investment. The witness advancing this unconventional approach has merely urged that the disparity between book yield and "true yield" be recognized in a larger return allowance and provided little in the way of support for the application of his alternative method. In these circum-

stances, his approach cannot be used in resolving the rate of return issue in this case.

We now turn to the earning experience of the production industry to fix the return to be allowed in this proceeding. Staff witness Shaffner's Exhibit 176 analyzed in Schedules 11 and 12 the 1957-1961 rates earned by two classes of producers: those that were principally engaged in production, and those that were also engaged in refining and marketing. The schedules, based on *Moody's Industrials and Annual Reports to Stockholders,* were limited to companies with interstate sales to pipelines in

excess of 2,000,000 Mcf annually, with actively traded common equity, and with a policy of making periodic reports of their earnings posture.

The Staff Exhibit 176, Schedule 11, reveals that the average returns for nine companies confined to production functions in each of the years 1957-1961 were, respectively, 13.9, 10.9 (including an .8 percent return for one company), 12.4, 11.6, and 13.2 percent, which produced an average of 12.4 percent, and a five-year median of 10.9 percent. When only the experience of the seven Permian producers is reflected the returns for the same years are as follows: 15.0, 12.4, 13.9, 12.5, and 13.4 percent, making an average of 13.4 and a median of 11.3 (Exhibit 176, Schedule 12). These

staff figures are consistent with respondent witness Morton's Exhibit 220, showing that 13 producers engaged solely in production, including six not covered by 13.0 and 14.4 percent over the same period. This produced an average return of 14.5 and a slightly lower median of 14.4 percent.

Both the Staff exhibits and the presentation of Witness Morton were limited in the number of individual companies covered; the latter also employed subjective considerations in selection and was forced to report on a less comparable basis. Nevertheless they are the best record indication of what the production function traditionally returns. We conclude that they are entitled to heavy consideration in the decisional process in this case.

Witness Shaffner's second category was comprised of 26 integrated producers. The average return experience for these companies was 10.0, 7.9, 8.1, 8.2, and 8.2 percent for the indicated years, which gave a five-year average of 8.5 percent and a median of 8.1. When limited to the 24 integrated Permian producers, the figures decreased slightly: 9.9, 7.8, 8.0, 8.0, and 7.8 percent, for a five-year average and median of 8.3 and 8.1 percent, respectively.

On a general average basis, the resulting return was 9.5 percent for both the national and Permian producers. On

an average weighted by capitalization basis, both national and Permian-only, the resulting return was 9.3 percent, reflecting that the total capitalization for the 26 integrated companies was over 40 times that of the nine non-integrated companies.

The Shaffner study of the returns of integrated producers standing alone fails to make a persuasive showing that the results are the best evidence of the financial needs of the gas operations of the companies involved. It covers the most widely diversified segment of the industry, those whose revenues were derived from the sale of petrochemicals, fertilizers, plastics and gasoline, as well as from transmission, distribution, real estate and manufacturing enterprises. The exhibits in the record, and the sources upon which they are based, offer no ratio of the integrated company oil and gas production revenues to total revenues, although they do reveal that revenues generated by natural gas sales to pipelines accounted for but 2.22 percent of total revenues. Without a departmental segregation of costs and revenues, it is impossible to calculate production department returns. It may be that on a different record the returns of integrated producers may be shown to be highly relevant but without any assurance that production returns approximate overall returns, we cannot automatically attribute the latter to the former. Accordingly, while we are persuaded that integrated producer returns are relevant to the instant issue, we are not persuaded that the Shaffner exhibit sufficiently weights production operations in his recommended return of 9.5 percent.

After weighing all the evidence on the issue we believe a return of 12 percent is appropriate in light of the considerations previously discussed and the presentations in this case, particularly the testimony of witnesses Shaffner and Morton with respect to the returns by nonintegrated producers in the Permian Basin. A return of 12 percent on production activities protects gas consumers against excessive prices but it is not so low that it fails to respond to the needs of the industry. It also considers the needs of the smaller independent who traditionally drills much of the Permian exploratory footage and his limited resources to weather even a brief series of unproductive expenditures. It may

be that another result may be reached on a different record but in this first area rate proceeding we believe the record points to a return of 12 percent and it is therefore adopted.

The presiding examiner, having determined that the total production investment would be recouped over an average period of 10 years beginning an average of 1 year after investment, correctly concluded that the total return to be allowed on each Mcf of gas should be based on an investment base that is 11 times the production investment per Mcf found. As the production investment was found to be 3.95 cents per Mcf, the investment base here is 43.45 cents. The annual return per Mcf should be

computed by multiplying 43.45 cents by the 12 percent rate of return, producing a figure of 5.21 cents per Mcf.

Return on Working Capital

To the return on net investment must be added the return on a working capital allowance. While in this proceeding the return on the allowance is a small item, it raises a policy question for decision.

Distributor witness Roseman presented a working capital computation in Exhibit 224 which follows the traditional utility formula of allowing in the rate base for a 45-day lag in collections; that is, a return is allowed on the sum of one-eighth of annual production operating expenses, one-eighth of annual exploration expenses, and amounts invested in supplies, materials and prepayments allocated to the exploration and production functions. The resulting allowance is 1.63 cents per Mcf which, at a 9½ percent rate of return, gives a .16 cent return. The presiding examiner accepted the method but, substituting 12 percent, allowed a .20 cent return.

The producers contend that the utility formula is inappropriate for the producing industry because it excludes funds that must be kept available for lease plays, drilling failures and exploration. They point out that their ratio of net plant to total capitalization is far smaller than in the transmission industry, and consequently, recurring cash needs, which are not covered by the return on net

investment, become more significant. The producers advocate a "balance sheet formula" which would allow a full return on the current net assets. They conclude that a representative allowance would be either 23 percent of total capitalization, which is the ratio of actual working capital to total capitalization for the thirteen non-integrated producers covered in their Exhibit 220, or 17 percent, which purportedly represents the ratio found in the Chase Manhattan Bank 1960 study of the actual cash portion of current net assets to net plant for the integrated companies. The Staff reply brief, however, correctly points out that the actual cash portion is but 6.7 percent, the other 10.3 percent representing marketable securities.

Staff and the distributors attack the balance sheet formula. They contend that it inappropriately allows a return on such items as total cash on hand, marketable and capitalized securities, accounts and notes receivable, and — in the case of the integrated producer — current assets applicable to refining and marketing. They argue that because net current assets have no reasonable relationship to the function of the working capital allowance, the balance sheet formula has been uniformly rejected by this Commission and the Courts. Staff concludes that the Commission has regularly employed the utility formula for producers and that other sources assure the availability of sufficient funds. Consequently, no further allowance is appropriate.

The Commission was first presented with a balance sheet approach in *Cities Service Gas Company*, 3 FPC 459 (1943), where it rejected the method as being "* * * unsound and inherently fallacious for ratemaking purposes." 3 FPC at 478. The case was affirmed, 155 F. 2d 694 (CA10), cert. denied, 329 U.S. 773 (1946). The Commission reaffirmed this conclusion in *Northern Natural Gas Co.*, 11 FPC 123 (1952) and the reaffirmance was specifically upheld in *Corp. Comm'n of Kansas* v. *F.P.C.*, 206 F.2d 690 (CA8 1953), cert. denied, 346 U.S. 922 (1954). The method was also rejected in *Panhandle Eastern*

Pipeline Co., 13 FPC 53 (1954), *rev'd on other grounds, City of Detroit* v. *F.P.C.*, 230 F.2d 810 (D. C. Cir. 1955). The balance sheet approach now urged upon the Commission incorporates the same flaws as found in the previous versions of this method. As herein presented, it is insufficiently refined and meaningful to be a legitimate regulatory formula, and we see no reason to depart from the sound reasoning of the *Cities Service* decision.

We are convinced that the balance sheet approach must be rejected and conclude that the four additive factors in the utility formula — cyclical expenses, materials, supplies and prepayments — are justified components of a working capital allowance for the producing industry, and that the formula is appropriate for calculating these

factors. We appreciate, however, that the erratic nature of individual company lease acquisitions, the competition among producers for attractive leaseholds, and the established practice of the industry to generate its own capital, demand that additional liquid sums be kept available. Accordingly, a compensatory "lease play" return must be allowed on reasonable amounts in excess of the working capital allowance based on the traditional utility formula.

Such funds in reasonable amounts are not idle or dormant in a meaningful sense. They are being employed as the exigencies of the business demand: in ready reserve for expenditures upon which the contribution of the industry depends. Such funds are not surplus, because they could not be dissipated without adverse effect on the exploratory effort. Moreover, there is no likelihood that they will be retained merely to inflate rate bases. Producers are relatively assured of receiving a return on funds invested in securities, and they have a fair opportunity of receiving a return on funds invested in the producing industry. Perhaps the most persuasive reason why excess sums are unlikely to be retained is that producers reduce their tax liabilities by a continued investment in the industry; the depletion allowance, by law, can offset no more than 50 percent of net income from a productive lease. This immediate tax benefit accruing from reinvestment far outweighs any incentive to mere accumulation.

We find that the producers must be given a return on the funds retained for lease play in addition to the 0.20 cent per Mcf return allowance computed under the traditional utility formula. An exact amount for this additional allowance is difficult to determine from the present record. Presuming that the producers should be allowed a return on liquid funds on hand equivalent to one and one-half times their per Mcf expenditures for lease acquisitions, return on the allowance for lease play would be approximately 0.15 cent per Mcf.[29] Future proceedings may elicit a more precise method for computing this amount.

For the purposes of this case, 0.15 cent per Mcf will be added to working capital as a lease play return allowance, making the total return on working capital 0.35 cent per Mcf.

ROYALTIES

Both Witness Roseman and Witness Park included royalties at the rate of 12.5 percent in their computations of cost. The presiding examiner accepted this figure and no participant demurs to the inclusion of such an item or to the 12.5 percentage. The examiner's figure of 2.11 cents per Mcf will be adjusted to 2.05 cents per

[29] As determined herein, the annual lease acquisition cost per Mcf is 0.76 cent. A lease play allowance based on a 12 percent rate of return on one and one-half times this 0.76 cent per Mcf amount would be .137 cents per Mcf.

Mcf to reflect the changes in the total amount on which the 12.5 percent royalty is computed.

PRODUCTION TAXES

The present Texas production tax is at the rate of 7 percent of lease revenues. Production taxes in New Mexico are somewhat lower than in Texas. The presiding examiner used a weighted average of Texas and New Mexico production taxes, which he computed to be 6.42 percent after taking into account the latest increase in New Mexico taxes.

We think that reasonable local taxes are a valid basis for a difference in ceiling prices between one area and another and if reasonable the tax applicable in each state should be applied to the gas produced in that state. The 7 percent tax in Texas is at approximately the maximum level of taxes which we have allowed to be passed on by the producer to the purchaser. Accordingly, the full amount of taxes actually incurred either in Texas or New Mexico will be allowed as a component of the total price per Mcf of gas. Since the greater part of gas produced within the Permian Basin is subject to the jurisdiction of the State of Texas, all ceiling prices set forth in this opinion will be stated in amounts applicable to gas produced within the taxing jurisdiction of that state. However, the ceiling price for sales in New

Mexico will reflect the applicable tax in that state and will, accordingly, be at lower levels.

In the event of any increase in taxes in Texas or New Mexico, the Commission will consider whether ceiling prices shall be increased and, if so, to what extent.

The ceiling price here established will be the total amount to be paid by the buyer of gas, including all tax reimbursements provided by contract.

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INCOME TAXES

Respondents presented no evidence that any income tax allowance should be included in the computation of cost of new gas-well gas. Their witnesses, Park and Keane, included no such allowance. At stated by the examiner, the testimony of Staff Witness Lyon shows that if the industry's growth is considered, there will be no Federal income tax liability at any return up to 15 percent. The Major Producer Group argues that 0.6 cent per Mcf should be included in the cost computation, representing income tax liability upon a return at the rate of 12.5 percent based on testimony by Witness Roseman. However, Roseman qualified his calculation by stating that many major companies in the past have been found to pay no income taxes, and that there is no evidence that taxes would in fact be paid. He further indicated that his computations should be revised in the light of additional data which was never introduced into the record.

In these circumstances we think the analysis of Witness Lyon was properly accepted by the examiner and we affirm his conclusion on this issue.

THE RATE FOR NEW GAS-WELL GAS

As we have stated the basic standard for determining the price of new gas-well gas is the cost-finding technique we have employed herein. However, in determining the price for each particular area the Commission must, of course, consider other relevant factors in the area. The factors which are commonly considered in the design of rates include the impact of the prescribed rate on existing rate structures, the quality of the gas in the area, the historical prices in the area and other such factors.

The presiding examiner made two adjustments from his cost base on account of such factors in designing his ceiling price for the Permian Basin. Both were of major size. One was a downward adjustment of 1.25 cents in the ceiling price for new gas-well gas (his so-called "location factor") to reflect the fact that historically the average initial price for new gas in the Permian Basin has been lower than the comparable price in the 7 southwestern

states.[30] The second adjustment was in the other direction and consisted of an addition of 1.0 cent as a so-

[30] He used the seven southwestern states because figures for continental United States were not available.

called "gold standard" to reflect the fact that much of the gas in the Permian Basin was of less than pipeline quality and his view that such a premium should be permitted for pipeline quality gas.

We do not believe that either of these adjustments is appropriate. Rates should of course be designed so as to minimize any disturbances of existing pricing patterns to the extent possible consistent with the basic regulatory standards. However, nothing in the record in this case suggests that the ceiling prices we are prescribing for the Permian Basin require any such adjustments. No adjustment for "location factor", whatever that vague concept may mean, is required or is appropriate in this proceeding, either in the amount prescribed by the examiner or in any other amount.

As to the "gold standard" adjustment, we have made clear that the ceiling prices prescribed herein apply as true ceilings for gas or pipeline quality and we have accordingly prescribed standards of pipeline quality. These standards provide for both upward and downward adjustments in the ceiling price for new gas-well gas. The record is deficient as to the overall financial impact of these adjustments but in our determination of rate of return we have recognized that producers in the Permian Basin incur the risk that the gas they find and produce may not command the ceiling price. The absence of any definitive record support for a "gold standard" adjustment coupled with our reflection of the quality problem in fixing the rate of return satisfies us that area revenue requirements will be met.

In summary, when all of these factors are considered there is no justification in this area for any adjustment of a cost-determined ceiling price. We state again

that the ceiling price we are here establishing is for the Permian Basin and that it is entirely possible that in other areas non-cost considerations may require adjustment of the cost figures in establishing the ceiling prices. We hold only that no such adjustments are required in the Permian Basin on the basis of this record. Accordingly we shall round off the cost determined price of 16.43 cents and prescribe a ceiling price for new gas-well gas of pipeline quality in the Permian Basin at 16.5 cents per Mcf at 14.65 psia for gas produced and sold in Texas. The ceiling in Texas includes a production tax of 1.01 cents, which we round off to 1.0 cent, leaving a rate less production taxes of 15.5 cents. For gas produced and sold in the three New Mexico counties, Chavez, Lea and Eddy, the ceiling price shall therefore be 15.5 cents at 14.65 psia plus the applicable production taxes in effect as of the date of this opinion. These prices will apply to residue gas derived from new gas-well gas (see discussion pp. 75-76).

RATIONALE FOR A UNIFORM CEILING PRICE FOR FLOWING GAS

Casinghead Gas

Casinghead gas is the common name for gas produced from oil wells in conjunction with the production of oil.

For purposes of the application of our ceiling prices herein, we shall follow the existing classification of casinghead gas by the appropriate state agency. Casinghead gas is often higher in Btu content than either residue or gas-well gas, and usually contains valuable liquids which are extracted before the gas is delivered to a pipeline. Casinghead gas is often delivered at low pressures, sometimes as low as 5 psig. Since oil wells in the Permian Basin are subject to restraints imposed by state regulation upon the amount of oil produced, casinghead gas can be obtained from a given well only for the period each month that oil is under state oil production controls. Correspondingly since oil is the major product of an oil well, taking the casinghead gas cannot be deferred for any length of time for the buyer's convenience; it must be taken at the time the oil is produced, and the amount of gas is related to the oil production.

Accordingly casinghead gas is not subject to the exclusive control of the buyer as to time of delivery. Ordinarily, however, processing plants will schedule deliveries from the various wells which they service in such manner as to maintain a substantially even output, so that irregularities in deliveries from particular wells are overcome to some extent for the pipeline purchasers from the processing plants. Nevertheless, this limitation on the deliverability of casinghead sometimes requires the pipelines to draw on additional gas-well gas to meet their commit-

ments, and gas-well gas sources therefore provide a valuable flexibility in meeting the peak requirements of the pipelines.

Most of the casinghead gas sold in the Permian Basin is sold to processing plants under percentage contracts, which provide that the processors shall pay to the producers a stipulated percentage of the price which the processors receive upon sale of the residue gas plus an agreed percentage of the proceeds of sale of the extracted liquids. Under these arrangements, the price paid by the processor is immaterial to the consumer so long as the price of the residue gas conforms with the ceiling price established for such gas in this proceeding. The processor is controlled by certificate and rate schedule filings and producers who sell casinghead gas under such percentage contracts are not permitted to file rate schedules with this Commission (Regulations Under the Natural Gas Act, Sec. 154.91(e)). So far as such producers are concerned, any separate ceiling price for casinghead gas would have no application.

The second major type of contract under which casinghead gas is sold in the Permian Basin is the so-called Spraberry or El Paso contract. These contracts provide for the purchase of casinghead gas by a pipeline which processes the gas, pays the producer a percentage of the proceeds from the sale of the extracted liquids, plus a fixed price for the residue gas delivered to the

pipeline. The examiner held that the payment arrangements provided for in the Spraberry contracts must be discontinued. He fixed ceiling prices of 10 cents per Mcf for old casinghead gas and 11 cents per Mcf for new casinghead gas, to be paid for the raw stream (including liquids) without any additional compensation to the producers in the form of a percentage of the liquids or of the price received for them. In effect he outlawed the Spraberry contracts and declared that only a flat amount, limited by the separate casinghead gas ceilings, could be paid for casinghead gas purchased under the Spraberry contracts.

The Major Producer Group has taken strong exception to this ruling, contending that pipelines will not be able to purchase casinghead gas if the presiding examiner's proposal is implemented because producers would then prefer to sell to the processors under percentage contracts. They also assert that the Commission has no jurisdiction over the division of the extracted liquids.

We believe the presiding examiner was correct in holding that the sale of the casinghead gas to the pipeline under the Spraberry type contract is subject to Commission jurisdiction, and that this Commission has the power to regulate the price for the raw gas purchased even though it may include the heavier molecules which can easily be liquified. The form of the contract provides for the transfer of title to the gas as casinghead or raw

stream gas but the method of payment is based upon a specified price per Mcf for the residue volumes of gas and a percentage payment of liquid revenues. The Commission has no jurisdiction over the price at which liquids are sold but if payment for the raw stream is made in whole or in part on the basis of a percentage of liquids or liquid revenues, the Commission may still consider the liquid credits in controlling the amount of the payment for the gas.

The fact that the transaction is subject to our jurisdiction does not mean, however, that we must reject a common form of contract which has been found useful in the industry. We believe that regulation should utilize industry practices developed by the parties to meet industry problems to the extent consistent with maintaining effective regulation. The Spraberry contracts govern approximately 20 percent of the gas sold in the Permian Basin, and we do not think they should be discarded unless it can be shown that they give rise to abuses or evasions, or result in unjust and unreasonable prices to consumers. So long as the cost to the pipelines for residue gas under the Spraberry contracts does not exceed the applicable ceiling price for gas of similar quality, we see no reason to require the elimination of the Spraberry contracts.

There is no evidence in this proceeding that the pipelines' cost of gathering and processing the casinghead gas

purchased under Spraberry contracts is greater than the revenues realized by the pipeline from the liquids extracted. As long as the liquid revenues to the pipeline equal or exceed the processing and gathering costs the consumer will be adequately protected by the ceiling here established for residue gas. If the cost of gathering and processing exceeds the pipelines' liquid revenues by an amount which, if added to the price paid for the residue gas, would exceed the ceiling price applicable to residue gas of similar quality, and appropriate reductions of the price cannot be negotiated, the purchasing pipeline may petition the Commission for relief pursuant to Section 5(a) of the Act by ordering an appropriate reduction in the price the pipeline pays for such residue gas.

Aside from gas sold under percentage contracts and Spraberry type contracts, only a negligible amount of casinghead gas is sold in the Permian Basin. In 1960, only three such contracts involved sales in interstate commerce of Permian Basin casinghead gas to pipelines. These contracts involved total revenues of less than $200,000 in 1960. The impact of these contracts upon prices to be paid by the ultimate consumer is *de minimis*. The contract prices were all under 14 cents. Additional reductions in price for quality deficiencies would reduce the actually realized prices still further. The effect of these contracts is too small to warrant the establishment of a separate ceiling price for casinghead gas.

Aside from percentage contracts, there are also few contracts for sales in interstate commerce of casinghead gas to producer-owned processing plants in the Permian Basin. These contracts will have no direct effect upon the cost to the pipelines and the ultimate cost to the consumer, since the resulting residue gas sold by the processing plants will be subject to the ceiling price herein established for residue gas derived from casinghead. In the event it should be determined that these contracts have a sufficient effect upon the cost of the processing plants so that the latter must seek relief before this Commission, we may then consider whether the prices under such contracts must be subjected to additional regulation. The record in this proceeding does not reveal the need for any such regulation. In general, the prices under such contracts are at sufficiently low levels so that the processors should be sufficiently protected. We establish herein a ceiling price for all gas (except new gas-well gas and residue derived therefrom) which will be applicable, of course, to such contracts.

We believe it is of great importance to simplify the system of area rate ceilings to the extent practicable consistent with an effective system of price controls. In this light we conclude that there is no need for a separate casinghead gas ceiling in the Permian Basin at this time. In the future, should the lack of such a ceiling be found to encourage evasions of the general price ceiling, a

separate ceiling price for casinghead gas may be established. With respect to the Spraberry contracts and all other contracts which, in addition to a payment for residue gas, call for payment for a percentage of liquids or turning over a percentage of the liquids to the producer, any alteration in the price paid for the residue gas or the percentage of the liquids due to the producer will be considered a rate change which must be filed with this Commission and the right to make such rate changes will be subject to the moratorium on rate increases imposed herein. *Future contracts* embodying such provisions are to be certificated only where the liquid percentage to be retained by the processor or the pipeline equals or

exceeds the cost of gathering and processing performed by the processor or pipeline, or where the price to be paid for the residue gas is reduced below the applicable ceiling sufficiently to offset processing and gathering costs in excess of the value of the liquids retained by the processor or pipeline. In the absence of a contrary showing, percentages similar to those now in effect will be assumed to be compensatory and will be approved in future contracts for comparable gas under comparable circumstances.

Residue Gas

Residue gas is the gas remaining after casinghead gas or gas-well gas has been processed to remove liquids pres-

ent in the raw gas stream in the form of vapor or droplets. Only three to four percent of the residue gas produced in the Permian Basin is derived from gas-well gas; between 96 and 97 percent comes from casinghead gas.

Residue gas in the Permian Basin is delivered at somewhat lower pressures, on the whole, than is gas-well gas. Most residue gas is delivered at pressures below 800 pounds, but deliveries of gas-well gas at pressures of 1,000 pounds and up are not uncommon. The cost of raising the pressure of gas to a given point is not proportionate to the added pressure, but is determined by the number of stages of compression (and the compression ratio) necessary to create the desired pressure. To raise the pressure of gas from 600 pounds to 800 pounds will normally cost little more than to raise it from 700 pounds to 800, since in each case only one stage of compression will be necessary.

For purposes of applying the area prices prescribed herein, the ceiling price for new gas-well gas will be applicable to residue gas which is derived from new gas-well gas and the ceiling price for all other gas will be applicable to residue gas derived from casinghead gas or old gas-well gas.

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We regard our determination that all gas should be priced on the same basis as old gas-well gas (except for the top ceiling we have established to encourage the

search for new gas-well gas which is applicable to such gas whether or not it has been processed) as an important step toward simplified and realistic area price regulation. It is apparent, on this record, that no realistic cost of oil-well gas either as casinghead gas or residue gas can be established and that the various apportionments of the joint costs of gas and oil, or gas and liquids, do not yield results which may be accepted as reliable guides. The evidence in this case and the practical administration of area prices dictates that casinghead gas, residue gas derived therefrom, and old gas-well gas, should be similarly priced. Unlike new gas-well gas, there is no basis on this record for differentiation because of the incentive effect, or otherwise.

The examiner would provide separate ceiling prices for old residue gas and new residue gas. We do not believe such a complication of the area pricing structure is necessary or desirable. We have already made clear that the higher ceiling price for new gas-well gas will apply in the case of residue gas derived therefrom. However, over 96 percent of the residue gas produced in the Permian Basin is derived from oil wells, not gas wells. It results from the search for oil, which will not be stimulated appreciably by a higher price for gas. There is thus little to be expected in the way of increased gas supplies from providing a higher price for such residue gas. All residue gas derived from oil-well gas, therefore, will be subject to the same ceiling price as old gas-well gas.

As stated above, we adopt the presiding examiner's finding that residue gas derived from new gas-well gas is to be subject to the new gas-well gas ceiling. If this were not the case, producers of new gas-well gas would be deterred from selling such gas to a processor from whom they were unable to obtain new gas-well gas prices. With equal prices, gas-well gas will be sold to a processing

plant whenever the sum received for the liquids exceeds the cost of processing. This is as it should be for it would be contrary both to good conservation practice and good economics for price regulation to interfere with the normal operation of market forces where these forces tend to provide the greatest possible benefits to the economy as a whole.

Hunt urges that residue gas must be priced higher than gas-well gas so that a processor selling residue gas can cover his processing costs plus a return on his investment in addition to the price of the gas-well gas he purchases. This reasoning ignores the fact that saleable liquid hydrocarbons are derived from the gas that is processed. The principal purpose of such processing is the removal of these liquids so that revenue may be realized from them. There is every reason to believe that the value of the liquids will be sufficient to justify gasoline plant processing of new gas-well gas. If not, there is no apparent economic reason to encourage the processing at gasoline plants.

We therefore reject the argument that the price of residue gas derived from gas-well gas should exceed that of gas-well gas. For the future, if processors of gas-well gas cannot buy gas-well gas at a price which enables them to make a profit on their operations at the ceiling prices we prescribe, we assume that such gas will not be processed by the producers. As to presently existing contracts by processors for the purchase of gas-well gas, if proper price relationships cannot be negotiated relief may be afforded in a proper case under the special relief provisions set forth later in this opinion. There should be very few of such cases, in view of the extremely small percentage of residue gas derived from gas-well gas.

The Rate for Flowing Gas[31]

Basic Approach

In the previous section we explained why a separate ceiling is not appropriate for casinghead gas or for residue gas derived therefrom and why the cost of old gas-well gas may appropriately constitute the basic yardstick for establishing a single ceiling price applicable to all gas

[31] The term flowing gas in this section will be used to include all gas other than new gas-well gas or residue gas derived therefrom. It includes old gas-well gas, all casinghead gas, and residue derived from old gas-well gas or casinghead gas.

other than new gas-well gas. We proceed with a determination of the cost of old gas-well gas.

The examiner determined the cost of old gas-well gas by employing virtually the same method he used to establish the price of new gas-well gas, with certain cost components adjusted by trending to approximate cost levels in the prior years when the old gas-well gas entered the interstate market. The State of California and the Public Utilities Commission of California have urged that the historical composite cost-of-service for the Permian Basin area based on questionnaire data be used to determine the price of old gas-well gas. Staff's basic case consisted of a composite historical cost-of-service presentation which California Distributors and Staff in its reply brief suggest should be used as a check on the examiner's method of computation of the cost of old gas-well gas.

As we have previously found, the examiner's method which is designed to approximate needed expenditures for finding and producing future gas-well gas supplies is the proper one for fixing the price of new gas-well gas. However, flowing gas is in a different category. Changes in the price cannot increase substantially the total amounts of gas which are already dedicated to interstate commerce[32] nor can they materially affect the supply of oil-well gas which is discovered as a by-product of the search for oil, although they could to some extent affect

[32] To a small extent the price might affect the stage at which wells are abandoned because the proceeds of operation do not defray out-of-pocket costs.

the amount dedicated to interstate commerce in the future. The revenues received from flowing gas, should, therefore, be based on composite historical costs, including a fair allowance for expenditures for E & D. The price for flowing gas must also reflect the producers' need for revenues from their present sales to support future discoveries.

We believe that the most solid basis in the record for determining the just and reasonable price of old gas-well gas is the composite cost-of-service presentation for the Permian Basin made by the Commission's Staff. The presentation uses 1960 as a test year to determine the cost of old gas-well gas. An approach based on historical costs for flowing gas enables us to draw on the cost finding techniques applied in previous producer cases on an individual company basis. We shall, therefore, use the composite historical cost-of-service for old gas-well gas, for the 1960 test year, as the basis for the flowing gas price. While we place primary reliance on Staff's cost-of-service presentation, we shall later show that the examiner's method of trending back the new gas-well gas cost yields approximately the same cost and thus serves as a useful verification of our result.

It should be noted that we are utilizing a different cost-finding approach for flowing gas than that used in calculating the cost of new gas-well gas. The cost of new gas-well gas was geared to the cost of finding and

producing future gas supplies and as such was built up primarily from nationally published statistics and the questionnaire data which to a large extent identified costs that could be related to gas-well gas. We were thereby enabled to minimize the need for allocations. However, with regard to flowing gas our touchstone is the historical cost of the gas being produced in the Permian Basin in 1960. The primary data includes joint product lease costs and joint E & D expenditures, whereas for new gas-well gas the parties developed cost-finding techniques that minimized the allocation problems. In deriving the cost of the flowing gas-well gas, therefore, it is necessary to utilize allocations to a greater degree than for new gas-well gas (although to a much less extent than with casinghead gas) and for this reason the details of the cost computations of new gas and flowing gas will not be comparable.

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The basic evidence utilized in Staff's composite cost presentation was collected for 1960. In addition, certain trend information was obtained for prior years. These and related data reveal that the 1960 level of costs is fairly representative of the costs during the three year period ending in 1960. While unit costs were somewhat lower in the earlier years, they leveled off in 1958 and so far as the evidence shows have never since exceeded this level. The 1960 test year is, therefore, typical of current and future costs of the flowing gas and it is also

more than fair to the producers as a basis for just and reasonable prices for the prior years when costs were slightly lower. The alternative of a separate cost study for each of the years prior to 1960 would have presented an almost impossible task. At best it would have prolonged this proceeding greatly. Such an effort was not justified since little gas was selling in the 1954-1957 period at prices even approaching our ceiling as established herein.

Preliminary Questions

An initial question in using the composite cost-of-service approach for determining the rate for flowing gas is whether production costs should be determined on the basis of nationwide costs incurred by the producers operating in the Permian Basin or whether their Permian costs alone should be used. While the staff presented its evidence derived from the questionnaires to show costs both ways, it argued that the emphasis should be on the Permian Basin cost experience. The producers, on the other hand, argue that the nationwide basis should be used.

Other than for E&D, the data is available in the record to determine the costs incurred in the Permian Basin. The ceiling price we fix herein is an area rate for flowing gas in the Permian Basin, not a national price, and in our opinion should be based primarily on area costs.

The Major Producer Group argues that if area costs are used the demand for gas would tend to concentrate in the lower cost and lower priced areas at the same time that the lower

prices would tend to discourage exploration and restrict supply in the area. This argument, if valid at all, would apply only to new gas-well gas where the price we fix could materially affect future discoveries, and there we rely on national data. We are here determining costs and rates for flowing gas in the Permian Basin and for such gas we shall, therefore, use Permian costs to the extent feasible.

While the principle is important the issue is not a major one in this area because the difference between national and area production costs is approximately 0.25 cents per Mcf in Staff's presentation.

A further preliminary question arises as to the use of the questionnaire data from Appendix C, the simplified form designed for producers with less than 10,000,000 Mcf of annual jurisdictional sales in 1960. The Commission's Appendix B is a comprehensive questionnaire designed for the major producers, those with 1960 jurisdictional sales in excess of 10,000,000 Mcf. Replies to the major questionnaire (Appendix B) were received in complete form from 67 respondents in the area. These respondents included 42 major producers[33] and 25 producers of less than 10,000,000 Mcf who voluntarily com-

[33] This total includes all the major producers in the area, except one who did not fill out the questionnaire in a usable manner, although given ample opportunity to do so.

pleted the form.[34] Appendix C questionnaires were mailed to all of the over 350 small producers in the area but responses were filed by only 105 of them. Of these only 60 were sufficiently complete to be compiled. The Commission's staff computed the results of the responses to Appendix C separately but included the Appendix C data in its composite cost of service.

The examiner concluded that the data provided by the major producers with respect to their Permian production was fully representative of area costs, but that the response from the small producers in the Appendix C group could not be used because the percentage coverage of the small producers was not large nor was the same sample random.

We agree with the reasoning of the examiner. The issue is of a *de minimis* nature in any event because the percentage of gas produced in the Permian Basin by such producers is so small so that the results could not be affected appreciably. The unit cost of gas in this proceeding would be increased by less than 0.07 cents per Mcf even if Appendix C returns were included. In these circumstances we shall rely exclusively on the Appendix B cost data.

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[34] The returns from these 25 producers do not affect the cost computations to an extent that would change the results.

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The Composition of Costs

The total costs upon which the price for flowing gas is to be based may be divided into two principal categories: (1) production costs, which include operating expenses and DD&A (depreciation, depletion and amortization), as well as a return on the production investment and (2) exploration and development costs (E & D), which includes an allowance for the expenses incurred in the search for gas. We are not concerned with the gasoline plant costs which the staff considered and treated at some length because, as already explained, in this area we are determining a price based on the cost of gas-well gas which will also apply to residue gas from other than new gas-well gas.

Production Costs

The compilation of the production costs by the staff is essentially the task of compositing by type of lease the items reported by the producers in response to the Commission's questionnaire and allocating the costs between gas and other products. The allocation problems which we shall discuss herein are the principal difficulties, but there are a number of other issues which must be resolved. They include the treatment of combination leases, corporate common costs, reinjected volumes, the development of oil and gas legs for

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allocation of production costs, and lease play allowance. These somewhat technical issues are discussed in Appen-

dix C to this opinion. Otherwise the computation of the composite unit costs of production operating expenses, the composite rate base and the allowance for DD&A, simply involve the arithmetic of compiling the appropriate data. The results are shown in the summary at page 85.

Allocation of Production Costs by the Relative Cost Method

There is of course no allocation problem in computing the production costs of dry gas-well gas. However allocations are necessary for the gas from gas condensate reservoirs. In computing the production operating costs for flowing gas-well gas we shall utilize the relative cost method to divide the joint production costs between the liquids and the gas on the gas condensate leases with lease separation.[35] The basic rationale of the relative cost method is that joint production costs should be allocated in relation to the separate production costs of oil and gas. This method is analogous to the procedure used by United States agencies and approved by this Commission to allocate the cost of a multi-purpose hydroelectric dam between power, flood control and other beneficial uses.[36] The cost of the portions of a dam used for more than one purpose is allocated in accordance with

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[35] "Lease separation" refers to the separation of condensate liquids from the gas on the leased property, rather than by later processing.

[36] See, for example, order issued March 5, 1965, in Docket No. E-6383, Allocation of Costs, McNary Project, Columbia River Washington-Oregon, and attached Bureau of Power report.

the relative cost of a separate dam or other required facility for each purpose. Here the relative cost of each coproduct, gas and oil, is used as the basis of allocating the cost of producing the two products jointly.

The first step in the relative cost method is to determine the unit cost of oil from leases producing oil only (the "oil leg") and the unit cost of gas from leases producing gas only (the "gas leg"). The unit cost for each of the two separate products is then multiplied by the volumes of liquid and gas produced on the joint production leases. This provides a total relative cost for the liquids and gas produced on such leases and a ratio of gas cost to

total cost. This ratio is then applied to the total cost of the gas condensate leases in order to obtain the unit costs as they apply to the jointly produced gas.

While producer-respondents and the presiding examiner have questioned the use of the relative cost allocation method, it is relatively simple and workable, has been accepted in principle in our electric power work for decades, and has been repeatedly used and approved by the Commission in producer rate cases. *Phillips Petroleum Co.*, 24 FPC 537 (1960), affirmed *sub nom. Wisconsin* v. *F.P.C.*, 303 F. 2d 830 (1961), affirmed 373 U.S. 294 (1963), especially at pages 553 *et seq.*; *Hunt Oil Co., et al.*, 28 FPC 623, 624 (1962). The reasoning which supports the relative cost method of

allocation in computing individual company costs is equally applicable to composite area costs. The detailed application of the method and the arguments against it are dealt with in Appendix C.

Rate of Return

Among the most important issues is the rate of return for flowing gas. We have already discussed in detail the many factors which led us to conclude that a 12 percent return is appropriate. Two of these factors warrant a somewhat different treatment in considering the appropriate return for flowing gas. First, the great bulk of the flowing gas was not found as the result of exploration or development directed toward gas but rather as an incident to the search for oil. In evaluating the risk factor for flowing gas we must therefore consider that there was by no means the same degree of risk knowingly undertaken in finding such gas as in the case of new gas-well gas. On the other hand, much of the flowing gas in the Permian Basin is below pipeline quality and thus will not command the ceiling price prescribed herein and this problem of low quality is more pronounced in flowing gas than in new gas-well gas.

In our judgment these two factors of lesser and greater risk considered together with the other considerations in our previous discussion of rate of return, which apply equally to flowing gas, persuade us that a 12 percent return is appropriate. Also relevant to our conclusion is the fact that revenues from flowing gas are a factor in the

scale of exploration for new gas. Moreover, flowing gas includes new accretions of casinghead gas and residue gas resulting therefrom, the price of which may well determine the extent to which such gas is committed to the interstate market. Accordingly, we shall allow a 12 percent return on flowing gas.

Summary of Production Costs

Employing the relative cost method, making the other necessary determinations as discussed in Appendix C, and using the 12 percent rate of return, we arrive at 9.16 cents per Mcf for production costs, consisting of the following:

Production operating expenses	1.75
Depreciation, depletion and amortization	2.42
Return	4.99
	9.16

Exploration and Development Costs

Exploration and development costs pose a different problem than production costs. E & D covers dry hole expenses, geological and geophysical expenses, lease rentals, cancelled and surrendered lease expenses, and all other costs expended on nonproductive properties in the effort to find gas. Expenditures for E & D are not earmarked for particular producing areas but on the contrary are incurred on a nationwide basis by the major producers, who make these expenditures largely in accor-

dance with prospects for discovery rather than on an area-directed basis. No one disputes the fact that the E & D allowance for flowing gas should be computed on a nationwide basis.

The principal problem is the proper allocation of total E & D expenditures between gas and liquids. The allocation problem is illustrated in our *Phillips* opinion, 24 FPC 537, 555-562 (1960). After closely analyzing many possible allocation approaches the Commission adopted the use of the modified Btu method in the *Phillips* case and reaffirmed it in *Continental Oil Company*, 27 FPC 96, 104 (1962); *Hunt Oil Company*, 28 FPC 623, 624 (1962); and *H. L. Hunt*, 28 FPC 897, 901 (1962).

The modified Btu method of allocation in the *Phillips* case was designed to utilize as a basic standard the relation of the fuel value of gas to the fuel value of oil, but at the same time adjust this relationship to reflect economic trends and the needs of the public for continued exploration and development. Thus the Commission considered not only the ratio of Btu's in a barrel of oil and in an Mcf of gas (about 6 to 1 for *Phillips* production), but also the increasing demand for gas compared to oil, the deeper drilling needed in exploring for gas, the upward trend of gas production, the ratio of the market price of gas to the price of oil, and other matters. Emphasizing that its determination was based on judgment, the Commission determined that an economic

factor of 4 should be applied to the Btu content of oil to allocate *Phillips'* exploration costs. The resulting cost relationship of finding an Mcf of gas to one barrel of oil was then about 1 to 24, rather than 1 to 6 as on a straight Btu basis. The Commission pointed out that the result might well be different in a case, unlike *Phillips*, where rates were being determined for the future.

In the present area proceeding Staff, through Witness Lyon, advocated the general method used in *Phillips*, with certain refinements, the principal one being the use of separate economic factors for gas-well gas and casing-head gas, in place of the single factor provided in *Phillips*. The total national costs were apportioned by the Staff to the lease products on the basis of these factors, the amounts so allocated were divided by the respective national volumes of the lease products to determine national unit allowances, and these unit values were then imputed to the Permian sales.

The respondents proceeded differently. They propose to allocate the expenses of developmental dry holes on the basis of the well drilling intentions of certain producers who were polled, the expenses of exploratory dry holes on the basis of intangible drilling costs associated with successful wells, and remaining exploratory expenses on the basis of successful expenditures for gas reservoir reserves compared to oil reservoirs. For the separation of gas and condensate, respondents would convert the condensate back to vapor and allocate costs on the basis of the relative vapor volumes of the gas and the condensate.

The examiner correctly found the respondents' method unsound because it ignores the economic purpose of the driller. While a barrel of condensate is worth some 20 times the value of an Mcf of gas, under the producer's vapor volumetric method an Mcf of gas would be assigned about the same E & D expenses as a barrel of liquids which vaporizes to about the same volume as an Mcf of gas. We may also note that in the allocation of developmental dry hole costs there was a considerable degree of self-selection in the responses from the polled producers. Expressions of "intention" also involve subjective considerations. The data obtained are not the result of a random sample of all producers on an objective basis and do not offer a reliable foundation for fixing prices.

We have reviewed the evidence in the record on this issue and believe that Staff's general approach to the problem is sound but that the breakdown between gas-well gas and casinghead gas is an unnecessary complication of the allocation procedures.[37] The issue is one of exercising reasonable judgment in allocating the total cost between the coproducts.

The basic staff method has been attacked by both the producers and the examiner as being circuitous, in that

[37] The further breakdown between gas-well gas and casinghead gas would result in only a difference of 0.12 cents in the E & D expense allocated to flowing gas-well gas and involves the use of questionable value differentials.

the existing price of flowing gas-well gas is used as one of the bases for determining what the price of flowing gas-well gas should be. We are now able to remove an element of circuitry from such an allocation by reason of the fact that we have computed a cost of new gas-well gas of 16½ cents per Mcf by an independent cost finding technique. We are thus able to relate the price of oil fixed by the marketplace to a separately established price of gas, to aid us in making these allocations.

The record indicates that the 1960 average price in the field for liquids is $2.90 per barrel which would be related to the 16½ cents per Mcf price of gas which we have established herein. The questionnaire data in this record reveals that the ratio of Btu's in a barrel of liquids to Btu's in an Mcf of gas-well gas is 5.1 to 1. Utilizing this Btu ratio and the independently established

prices previously mentioned we arrive at a value relationship of a Btu of liquids to a Btu of gas-well gas of 3.45 to 1.[38]

There are other factors which must be considered in arriving at the economic factor for determining the appropriate allocations of E & D expenses between gas and oil. One such guide is the fact, established in the record, that the production costs of a Btu of oil are roughly 4½ times

[38] The price ratio of $2.90 per barrel of oil to 16.5 cents per Mcf of gas is 17.6 to 1. This ratio is then divided by the 5.1 to 1.0 Btu ratio to determine the value relationship of 3.45 to 1.

that of a Btu of gas. Another factor to be considered is that the 16½ cents price is one that we have determined to be appropriate for the future for new gas-well gas and that the price of gas moved sharply upward during the 1950's in relation to the price of crude oil. We must also consider that we are determining a cost to be used for fixing prices for flowing gas for the future as well as for the past.

These considerations and the other data from the record relating to the allocation question, lead us to conclude that in allocating total E & D expenses, an economic factor of 3.5 should be applied to the Btu's of crude oil and condensate liquids production as compared with an economic factor of 1.0 for the Btu's of all gas. Allocations on a Btu basis so adjusted in our judgment will give proportionate weight to the costs, prices, quality and other economic relationships of the respective hydrocarbons.

We also believe that these relative weightings should be applied to the national production of hydrocarbons, rather than to the Permian Basin production because E & D is conducted on a national basis.[39]

Applying these factors to the national production, the E & D costs for flowing gas-well gas would be 4.08 cents. The details of the computation are shown in Appendix C, pages 11-12.

[39] There is in this case little difference in the practical result, since the application of these factors to area production rather than to national production would change the results of the cost computation by approximately .01 cent.

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crease filings were approved on the basis of cost evidence.[7] In other cases where the producer failed to submit evidence founded on the conventional rate base method of regulation, the Commission dismissed the rate increase[8] on the assumption that in the absence of such cost support it was bound to do so by *City of Detroit* v. *F.P.C.*, 230 F. 2d 810 (CADC, 1955), certiorari denied 352 U.S. 829 (1956), a case dealing with a pipeline's own gas production. On review of these rate increase dismissals the Court of Appeals for the Fifth Circuit

agreed that the evidence as to field prices coupled with opinion testimony as to the need for an incentive price to induce adequate exploratory and development activity was not enough to demonstrate the rates were just and reasonable but held the Commission should have given the producers further opportunity to present evidence. The Court also indicated that the Commission need not require conventional rate base evidence if other cost evidence was available to insure that consumers were not paying more than a just and reasonable price, and need not fix separate rates for each producer if it found a uniform rate for the field desirable.[9]

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[7] See *e.g., Davidor & Davidor,* 15 FPC 1236 (1956).

[8] See *e.g., Union Oil Co. of California,* 16 FPC 100, 110 (1956).

[9] *Bel Oil* v. *F.P.C.*, 225 F. 2d 548 (CA5, 1958), certiorari denied 358 U.S. 804 (1958); See also *Forest Oil Corp.* v. *F.P.C.*, 263 F.2d 622 (CA5, 1959).

The area concept also had its origin in proceedings under Section 7 of the Act upon applications for certificates of public convenience and necessity by gas producers. As early as November 28, 1955, in *Cities Service Gas Co., et al.*, 14 FPC 134 (1955), affirmed as *Signal Oil & Gas Co.*, v. *F.P.C.*, 238 F. 2d 771 (CA3, 1956), certiorari denied 353 U.S. 923 (1957), the Commission conditioned a producer certificate to the price level prevalent in the area (14 FPC at pp. 147-148). In some later cases the Commission failed to impose a condition on the initial price, the important example being the CATCO case,[10] relating to the offshore Louisiana area. As a result the Commission was reversed by the Supreme Court, which held that the Commission must impose a condition when the price was "out of line" in the area of production.[11] The area price concept was further developed in other cases remanding Commission orders granting unconditioned certificates.[12]

In the 1956-1959 period, a number of producer cases were initiated as investigations under Section 5(a) of the Gas Act. The first major case to reach the Commission

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[10] *Continental Oil Co., et al,* 17 FPC 880 (1957).

[11] *Atlantic Refining Co.* v. *P.S.C. of New York,* 360 U.S. 378, 391 (1959).

[12] See for example *United Gas Improvement Co.* v. *F.P.C.*, 283 F.2d 817 (CA9, 1960), certiorari denied 365 U.S. 881 (1961).

on the merits was the original *Phillips* case,[13] on remand from the Supreme Court. The Permian case is a direct outgrowth of *Phillips*. In that case the Commission first considered the numerous questions relating to Phillips' cost-of-service, including the difficult allocation of costs between Phillips' oil production and its gas production. While utilizing individual company cost-of-service to pass upon a limited number of increased rate filings, the Commission concluded that such an approach was not appropriate for fixing just and reasonable producer rates for the future. Accordingly, the Commission refused to fix Phillips' rates for the future on this basis. The Commission spelled out in detail the many reasons why the individual company cost-of-service approach did not offer a reasonable basis for determining the just and reasonable prices for sales of gas by producers in interstate commerce. It also pointed out that the administrative burdens of literally thousands of separate proceedings in itself demonstrated the complete infeasibility of attempting to achieve effective regulation on an individual company basis.

On the same day, September 28, 1960, that it issued its *Phillips* opinion the Commission issued its Statement of General Policy No. 61-1 (24 FPC 818 (1960), initiating the area rate approach by establishing guideline ceiling prices for the various producing areas. Separate levels were listed by the Commission for the initial prices at which it would certificate new sales of

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[13] *Phillips Petroleum Co.*, 24 FPC 537 (1960).

gas and for accepting without suspension price increases under existing rate schedules.

The Commission in prescribing guideline prices attempted to take into account all of the relevant information available to the Commission at the time. These

guideline prices did not purport to be the just and reasonable rates, but rather the interim guides the Commission would follow in issuing certificates and in deciding whether to suspend rate increases until just and reasonable rates could be determined after hearing in area rate proceedings. As a result of the guidline price policy, in a practical sense the area rate approach has been in effect on an interim basis for the past 4 years.

On review, the *Phillips* opinion was affirmed by the Court of Appeals and by the Supreme Court.[14] The courts upheld the Commission in going forward with the area method of regulation. The Supreme Court said (p. 310):

> We respect the Commission's considered judgment, backed by sound and persuasive reasoning, that the individual company cost-of-service method is not a feasible or suitable one for regulating the rates of independent producers. We share the Com-

[14] *Wisconsin* v. *F.P.C.*, 303 F. 2d 380 (CADC, 1961) affirmed 373 U.S. 294 (1963).

mission's hopes that the area approach may prove to be the ultimate solution.

The Commission has proceeded with its program to implement the area rate approach. In addition to the present proceeding, AR61-1, for the Permian Basin, a proceeding was begun on May 10, 1961, to determine area rates for the Southern Louisiana area, AR61-2, 25 FPC 942 (1961), and on November 27, 1963, area rate proceedings were instituted for the Hugoton-Anadarko Area, AR64-1, and for the Texas Gulf Coast Area, AR64-2, 30 FPC 1354 (1963). These four proceedings, which are all under way, have as their purpose the fixing of just and reasonable rates for about 75 percent of the gas flowing in interstate commerce.

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LEGAL BASIS FOR AREA RATES

In the second *Phillips* case (*Wisconsin* v. *F.P.C.*, 373 U.S. 294 (1963)) the Supreme Court, in holding that the Commission had not abused its discretion by rejecting the individual company approach, stated (pp. 308-309):

> * * * If we believed that such a departure from present concepts had little, if any, chance of being sustained, we would be hard pressed to say that the Commission had not abused its discretion in terminating this §5(a) proceeding while undertaking the area experiment. For if area regulation were

almost sure to fail, and if the individual company cost-of-service method of determining the reasonableness of rates had been abandoned, then there would be virtually no foreseeable prospect of effective regulation.* * *

But to declare that a particular method of rate regulation is so sanctified as to make it highly unlikely that any other method could be sustained would be wholly out of keeping with this Court's consistent and clearly articulated approach to the question of the Commission's powers to regulate rates * * *.

More specifically, the Court has never held that the individual company cost-of-service method is a *sine qua non* of natural gas regulation.

A number of producers contend nevertheless that we are pursuing an inherently illegal method of regulating the field price of natural gas. Sun, in particular, has been vigorous in asserting that the Natural Gas Act precludes us from fixing maximum area prices at a level lower than a producer could justify on an individual cost-of-service basis.

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Sections 4 and 5(a) of the Natural Gas Act provide the authority for regulating the rates of the producers upon which the area rate order is based, but the breadth of the statutory scheme is evidenced also by the other

provisions of the Act which confer broad regulatory authority over sales for resale by gas producers in interstate commerce. For example, Section 7 of the Act requires every producer to obtain a certificate of public convenience and necessity prior to commencing any interstate sale and also requires Commission approval before abandonment of any gas which has been dedicated to the interstate market. Section 16 of the Act empowers the Commission "to perform any and all acts and to prescribe, issue, make, amend and rescind such orders, rules and regulations as it may find necessary or appropriate to carry out the provisions of this Act."

This area rate proceeding includes numerous individual rate increase filings in the Permian Basin which have been suspended. The rates specified in the filings have been collected subject to refund under the provisions of Section 4 of the Act, requiring that all rates shall be "just and reasonable." The area rate order will also apply under Section 5(a) of the Act to those sales of the respondents in the Permian Basin which are not being collected subject to refund. Section 5(a) contains the statutory standard for fixing the future rates for the sales in the area since its provisions are also applicable to rates fixed under Section 4. Section 5(a) provides that:

> Whenever the Commission, after a hearing had upon its own motion or upon complaint of any State, municipality, State commission, or gas distributing company, shall find that any rate, charge, or classification demanded, observed, charged, or

collected by any natural-gas company in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and

reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order: PROVIDED, HOWEVER, That the Commission shall have no power to order any increase in any rate contained in the currently effective schedule of such natural-gas company on file with the Commission, unless such increase is in accordance with a new schedule filed by such natural-gas company; but the Commission may order a decrease where existing rates are unjust, unduly discriminatory, preferential, otherwise unlawful, or are not the lowest reasonable rates.

While Section 4 of the Act prescribes that "all rates and charges" by *any* natural gas company shall be "just and reasonable", there is nothing in the Act which states or suggests that the justness and reasonableness of a particular company's rates cannot be determined on a group or area basis, rather than in a separate proceeding for

each company. Operating under a statute with virtually the same rate-making provisions as the Natural Gas Act, the Secretary of Agriculture, with the approval of the United States Supreme Court, has long fixed maximum just and reasonable rates for all stockyard marketing agencies of a particular yard, based on stockyard-wide data, rather than individual rates based on the costs of individual agencies. See *Tagg Bros.* v. *United States,* 280 U.S. 420 (1930); *Acker* v. *United States,* 298 U.S. 426 (1936); *United States* v. *Corrick,* 298 U.S. 435 (1936). The Federal Communications Commission, also operating under similar statutory commands, has for a number of years fixed the maximum just and reasonable rates for the competing international telegraph common carriers on a "bell-wether" basis, refusing, in the interests of its statutory mandate of providing the public with "adequate facilities at reasonable charges" (47 U.S.C. 151), to fix the rates "so that all carriers engaged therein may earn a fair return on the fair value of their property devoted to that service or even make some profit on their operations." *Postal Telegraph-Cable Co., et al.,* 5 FCC 524, 527 (1938). See also *The Western Union Telegraph Co.,* 25 FCC 535, 577-580 (1958).

Another example is action fixing a uniform price for milk in a milkshed, a form of regulation which was upheld in the landmark case of *Nebbia* v. *New York,* 291 U.S. 502 (1934). See *United States* v. *Rock Royal Co-op.,*

307 U.S. 533 (1939) (upholding Federal milk marketing orders under the Agricultural Marketing Agreement Act of 1937, 50 Stat. 246); *Sunshine Anthracite Coal Co.* v. *Adkins,* 310 U.S. 381 (1940) (upholding Bituminous Coal Act of 1937, 49 Stat. 991, authorizing Bituminous Coal Commission to impose maximum and minimum prices on an area basis). For the regulation of railroad charges the Interstate Commerce Commission has employed territorial classifications and group rates. *New York* v. *United States,* 331 U.S. 284 (1947); see also *Ayrshire Collieries Corp.* v. *United States,* 335 U.S. 573 (1949).

It is thus well established that governmental price regulation of services and commodities can be lawfully exercised over industries providing commodities or services on a group or geographical area basis. Many different regulating authorities with jurisdiction over an entire industry or common group have been upheld in exercising their rate-making authority on a group basis rather than conducting separate proceedings for each individual company. Moreover, with special reference to rate regulation under the Natural Gas Act, the Supreme Court has long held that neither the Constitution (see *F.P.C.* v. *Natural Gas Pipeline Co.,* 315 U.S. 575, 586 (1942)) nor the Act itself imposes any special "formula by which the 'just and reasonable rate' is to be determined." *F.P.C.* v. *Hope Natural Gas Co.,* 320 U.S. 591, 600 (1944). See also *Colorado Interstate Gas Co.* v. *F.P.C.,* 324 U.S. 581 (1945).

The argument to the contrary stems primarily from a brief dictum in *Bowles* v. *Willingham*, 321 U.S. 503 (1944) in which the Court, in the course of upholding the lawfulness of war-time rent control legislation authorizing the Price Administration to fix, without advance hearing, maximum rents that were "generally fair and

equitable", referred to the then recent *Hope* case for the proposition that "under other price-fixing statutes such as the Natural Gas Act * * * Congress has provided for the fixing of rates which are just and reasonable in their application to particular persons or companies" (*id.* at 517). It is significant that this statement predates the first *Phillips* case and its determination of the existence of Commission authority over producer rates. At the time of the Court's statement in the *Bowles* case, the Commission had not yet undertaken a program for producer regulation and was, as it still is, regulating pipelines under individual company cost-of-service procedures. The Court's dictum contrasting group regulation under the rent control statute with the individual company regulation of pipelines cannot be interpreted to suggest that the latter would be the sole appropriate method of determining rates under the Act for producers whose business involves entirely different economic and administrative problems. On the contrary, the Court went on to state that "considerations of feasibility and practicality are certainly germane to the constitutional issue [of group

versus individual company pricing]" (*id.*), that *Hope* had indicated that "price control, the same as other forms of regulation, may reduce the value of the property regulated" (*id.*), and that though "high cost operators may be more seriously affected by price control than others * * * it has never been thought that price-fixing, otherwise valid, was improper because it was on a class rather than an individual basis" (*id.* at 518).

Both the constitutional and the statutory questions, in other words, are not to be decided abstractly, but rather in the light of the nature of the specific rate-making problem involved, and of what is required to achieve a sensible result. The necessity for accommodating the system of regulation to the circumstances of the industry being regulated was recognized by the Supreme Court in the *Nebbia* case, *supra,* in which it was held that due process under the Fifth and Fourteenth

Amendments demand only that government regulation "shall not be unreasonable, abritrary or capricious, and that the means selected shall have a real and substantial relation to the object sought to be attained" (P. 525). In the words of the Supreme Court in *Hope, supra,* at p. 602 "Under the statutory standard of 'just and reasonable' it is the result reached not the method employed which is controlling."

We believe the area approach should be adopted because it is well adapted to the economic facts of the

industry and the practical administrative problems of carrying out the primary purpose of the Act, which is to achieve effective price control. We remain of the view, originally set forth in our *Phillips* decision in 1960 (24 FPC at 547), that the area approach will enable us to carry out our ultimate objective of setting prices in all producing areas.

Basic to this determination is the fact that objective cost standards for fixing just and reasonable rates for producer sales can best be developed by examining overall producer experience. An individual producer may find only dry holes or marginal wells on his search for gas may result in finding a huge new gas field. A price fixed by his individual cost experience could thus either be too high for consumers in relation to other available supplies or too low to be fair to the producer, considering his risks. However, on a group basis, costs and rates can be developed which will be fair to all concerned. A uniform ceiling price for the area will provide a fair relationship between the aggregate price the consumer pays and the aggregate costs that the producers incur.

A uniform area pricing system is adapted to the economics of the natural gas industry. The producer who finds large reserves will achieve greater profits than the producer whose exploration efforts result in dry holes or marginal wells. Likewise, the producer whose enterprise is conducted with efficiency and economy will make

more money than the producer who runs his business poorly. There is a strong incentive in area pricing to prudence and economy which does not exist in individual company cost-plus pricing in an industry where individual cost norms are difficult to determine and apply. True, individual returns will vary greatly, but this is as it should be, provided that profits in the aggregate are at a reasonable level.

The area regulatory pattern thus conforms to the characteristics of an industry which, as much as any, is one where there is scope for greater or lesser reward as dictated by the results of exploratory efforts. The area price will give producers the incentive they need to explore to meet the nation's increasing demand for natural gas and yet give consumers the protection which the Act intended.

An obvious advantage of the area rate approach which is of great importance is that it enables the Commission to determine in a single proceeding rates which would otherwise require hundreds of individual rate cases. It will thus eliminate the administrative bottleneck of company-by-company determinations. As we have noted, the four area proceedings now under way will complete the task for 75 percent of the gas flowing in interstate commerce in the entire nation.

The individual company approach would also result in a wide variety of rates in a single field, and even for

the sales by co-owners from a single well, depending on their varying company-wide costs. Such a system would raise staggering burdens of administration. Administrative feasibility is a vital element in the effectiveness of any method of regulation and our experience dictates that it should be given great weight in assessing the validity of the area approach.

The cases do not support the producers' contention that a just and reasonable rate fixed on the basis of the overall costs and profits of the producers in the area would be constitutionally confiscatory as to any respondent who could support a higher price on an individual company cost-of-service basis. The Supreme Court in *Acker* v. *United States,* 298 U.S. 426 (1936) rejected the argument that the pricing orders of the Secretary of Agriculture, fixed on a group basis under the Packers and Stockyards Act, were confiscatory as to a particular market agency, concluding that "in ascertaining a reasonable unit cost as the basis of a uniform rate the Secretary was not bound to, and indeed he could not, adopt any one [market] agency's costs" (*id.* at 429) and that "regulation cannot be frustrated by a requirement that the rate be made to compensate extravagant or unnecessary costs" (*id.* at 431). See also *Tagg Bros.* v. *United States,* 29 F. 2d 750, affirmed *Tagg Bros. v. United States,* 280 U.S. 420 ("It is not incumbent upon the Secretary to fix the rates so high that all agencies in the business would make money whether they did a substantial business or not."); *Bowles* v. *Willingham, supra;* and *Aetna Insurance Co.* v. *Hyde,* 275 U.S. 440 (1928).

In the *Aetna* case rates of all the stock fire insurance companies doing business in Missouri had been reduced by the superintendent of insurance under a statute authorizing him to limit the rates charged so that the "aggregate collections" by all the companies would not exceed a reasonable rate. The superintendent reduced the rates uniformly and on appeal by the companies involved the Supreme Court concluded that the Fourteenth Amendment was not violated merely because the aggregate collections were not sufficient "to yield a reasonable profit or just compensation to all companies that happen to be engaged in the affected business." (p. 447)

Even in situations where it is appropriate to fix rates on an individual company basis, the courts have held that a company's rates may be fixed at a level below that which would be justified on a normal cost-of-service basis, where the low rates result from self-imposed contractual limitations. (See *F.P.C.* v. *Sierra Pacific Power Co.*, 350 U.S. 348 (1955)) In an analogous situation, it was early held that a turnpike was not entitled to higher tolls on the basis of cost-of-service evidence where the real problem was the low volume of traffic (Covington & Lexington Turnpike Road Company v. Sandford, 164 U.S. 518 (1896)).

These cases make clear that there is no constitutional infirmity in the statutory authority to fix just and reasonable rates on an area basis, and argue persuasively that

in group ratemaking individual costs cannot be controlling. To hold otherwise would convert a proceeding to control prices into one that merely established a minimum rate above which every producer would be free to justify an above-ceiling rate in an individual company determination. A procedure under which the area rate would become a floor rather than a celing would destroy the area rate concept as an effective means of regulation. Such an approach to our consumer protection responsibilities under the Natural Gas Act would be neither just nor reasonable.

While we will not permit a back-door approach to individual cost-of-service under the guise of avoiding confiscation, there may well be circumstances in which a producer would be entitled to relief from his obligation to continue to render service to the public at the area rate or to make refunds for past periods. Accordingly we shall provide an opportunity for producers to petition

for special relief from the area rate as set forth in detail at pages 104-107. We cannot here visualize all of the circumstances which may serve as the basis for such relief, and will provide adequate flexibility to consider claims to such entitlement, but it is obvious that more must be shown than that the individual producer's costs exceed composite costs.

We believe the record in this case, judged in light of our experience in administering the Natural Gas Act,

clearly supports the conclusion that the area approach offers a regulatory method which is best adapted to the discharge of our responsibilities for protecting natural gas consumers while providing the greatest incentive to producers to continue their search for needed additions to our gas supply.

CONTRACT PRICES AS A BASIS FOR REGULATION

In considering the appropriate guidelines for regulating producer rates on an area basis, we must dispose of one threshold argument. Certain of the producers contend that their contract prices should be approved as meeting statutory requirements because they have been reached as a result of what is termed effective competition. IPAA contends that the examiner erred in not adopting as the standard for determining area prices the "market value" as established by natural gas purchase contracts negotiated at arm's length. A number of other producers propose a slightly more sophisticated version of this argument under which the contract rates negotiated at arm's length would be allowed to govern as long as the ratio of proven reserves to production did not become inordinately high.

We recognize that the history of negotiated prices in the area is an important element to be considered in reaching our decision. However, the producers' contention that the Commission should simply validate their negotiated prices, if accepted, would amount to an abdication of our regulatory responsibility.

The essential difficulty with the contract price argument is that there is nothing in this record which would justify a conclusion that reliance on contract prices unrelated to cost will "afford consumers a complete, permanent and effective bond of protection from excessive

rates and charges", which is the purpose of the Act in prescribing that the rates and charges to consumers of natural gas should be just and reasonable. *Atlantic Refining Co.* v. *Public Service Commission of New York (CATCO)*, 360 U.S. 378, 388 (1959). See *Wisconsin* v. *Federal Power Commission*, 373 U.S. 294, 309-310 (1963). *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672, 685 (1954). There are admittedly many producers selling gas to the interstate pipelines both in the nation as a whole and the Permian Basin in particular, but nothing in this record suggests that any competition among them in making sales to the pipelines is in any way adequate to assure that the public will secure gas at just and reasonable prices in the absence of regulation.

The history of price negotiations in the Permian Basin area is relevant to this issue. When El Paso was granted a certificate to supply natural gas to the California market on May 31, 1946, 5 FPC 115 (1946), it had entered into contracts with Phillips, Gulf, Shell, and Warren for a supply of gas in the Permian Basin. El Paso was to pay to Phillips 3.5 cents per Mcf, Shell and Warren 3.0 cents,

and Gulf 4.0 cents. These prices were subject to escalation by one cent every few years and to spiral escalation clauses by which they would be adjusted upward if El Paso's resale rates increased at the California border. Later, the spiral escalation clauses were deleted and indefinite favored-nation escalation clauses were substituted, except in the case of Phillips.[15]

In 1953, the Commission certificated Permian Basin Pipeline Company (a subsidiary of Northern Natural, and since merged into it).[16] The initial price amounted to approximately ten cents per Mcf for pipeline quality gas and was subject to escalation of one cent every five years.

In 1959, Transwestern Pipeline Company, 22 FPC 391 (1959), obtained a certificate to build a new pipeline from the Panhandle-Hugoton area of Texas and Oklahoma and from the Permian Basin to California. For the producers supplying gas to the pipeline the Commission authorized 16-cent prices and one 18-cent price, but the contracts called for prices as high as 21.8 cents in the West Texas-Permian area and 23.0 cents in the Panhandle-Hugoton area.

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[15] A favored-nation clause in a contract generally provides that the contract price shall be increased to equal higher prices paid others in a given area. There are numerous variations of the basic concept. Spiral escalation clauses are also indefinite in amount and provide for increases in producer rates in proportion to increases in the rates of the pipelines that are purchasing the gas from the producer.

[16] *Permian Basin Pipeline Co.*, 12 FPC 85 (1953).

The escalation clauses in the contracts and the urgent pipeline requirements for large volume gas reserves contributed to a continuous rise in Permian Basin prices. As a result of these escalation clauses and the expanding need for gas the 2.8-cent per Mcf average price paid by El Paso in 1947, its first full year of purchases, increased to 9.0 cents in 1954, the year of the first *Phillips* case, and reached 13.8 cents per Mcf in 1960. In that year, El Paso renegotiated most of its Permian contracts to eliminate the indefinite price clauses but was required to agree to price increases. The new prices ranged from 13.5 cents per Mcf to 17 cents per Mcf for gas of high quality.

We do not suggest that this historical pricing pattern in and of itself demonstrates the invalidity of the contract prices now in effect in the Permian Basin. On the contrary, it is obvious that the extremely low prices prevalent during the earlier period of large oil-associated supply and small demand bear no relationship to the cost of exploring for and producing gas even in that period, to say nothing of the present. However, while the record indicates that the costs of the various producers in the field differ markedly, there is no evidence that any significant volumes of gas of similar quality have ever been offered for sale at prices which reflect these cost differences.

The pipelines are far from being in a bargaining position which would validate the theory that a market price

will necessarily be a just and reasonable price. On the contrary the entire history of pipeline purchasing activity, since the end of the El Paso monopoly in the Permian Basin, has been characterized by the overriding needs of the pipelines to contract for the large blocks of uncommitted reserves essential to maintain their competitive position in developing markets (see *United States* v. *El Paso Natural Gas Co.*, 376 U.S. 651 (1964) and their inability to accomplish this objective except at ever increasing prices. The abstention of the pipelines from these proceedings does not indicate that any significant change can be expected in the future. The fact that many pipelines are themselves producers with an interest in generally higher producer prices also cannot be overlooked.

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There is no basis for concluding that there would be any effective producer price competition even if the pipelines were in a position to encourage it actively. On the contrary, until action was taken by this Commission, the entire pattern of producer contracts in Permian was on a basis of favored-nation and spiral escalation contracts calculated to assure that all producers would be treated alike and receive the highest going price both at the time of the contract and in the future. Typically, where a large producer has been able to command a higher price for a big block of gas needed by a pipeline entering the market or preparing for a major expansion,

this has had the effect of raising the price to all other purchasers by all other sellers big and small, and regardless of their costs or profit ratios. Moreover it is obvious that a key factual question in determining whether there is effective competition is the amount of uncommitted reserves controlled by the large producers. The pattern of sales and annual deliveries in the Permian Basin strongly suggests that a limited number of producers control a large percentage of the gas reserves,[17] and it is significant that the producers in the exclusive possession of the facts have made no showing to rebut this conclusion.

In *United Gas Improvement Co.* v. *F.P.C.*, 290 F.2d 133, 135 (CA5, 1961), certiorari denied 368 U.S. 823 (1961), it was said that the supply of gas controlled by the producers is so restricted in relation to demand that they have economic power to bargain for prices that will be injurious to the public. The Court held that the Commission in exercising its authority may not act merely upon proof that the prices in question were arrived at as a result of arm's-length negotiation, but must look behind the negotiated price. See also *P.S.C. of New York* v. *F.P.C.*, 287 F.2d 146 (CADC, 1961), *United Gas Improvement Co.* v. *F.P.C.*, 287 F.2d 159 (CA10, 1960). In so holding the court was reiterating the position it had taken in a series of cases involving just and reasonable

[17] The record reveals that 5 producers account for about one-half of the jurisdictional sales in the Permian Basin and 15 producers make about three-fourths of all the sales of gas in the area.

rates for independent producers under Section 4 of the Act in which it had concluded that:

> * * * evidence of unregulated prices in the field is not sufficient to warrant a finding by the Commission that a price comparable to them is just and reasonable within the

> intendment of the Natural Gas Act. Neither is evidence of the field price when coupled with the opinion of experts that the price must be high enough to provide an incentive for exploration and development of new sources of supply."[18]

If there is a case to be made for effective competition among producers in establishing just and reasonable rates it has not been made on this record. There is no evidence of competition between producers to make new sales by offering lower prices. On the contrary, the primary competition revealed by the record was among the pipelines to secure new gas supplies at higher prices. Whatever the

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[18] *Bel Oil Corp.* v. *F.P.C.*, 255 F. 2d 548, 553 (CA5, 1958) certiorari denied, 358 U.S. 804. See *Forest Oil Corp.* v. *F.P.C.*, 263 F. 2d 622 (CA5, 1959); cf. *City of Detroit, supra.* As the court indicated in the *Bel Oil* case the expert testimony purported to show that petitioners "did not possess any dominating position in the industry, that natural gas is competitive with other non-regulated fuels, that the proposed prices were comparable with unregulated prices for local consumption; that maintenance of such a price is necessary to provide appropriate incentives for exploration and production of natural gas in Louisiana." (p. 551)

degree of competition which may exist among producers it has not been effective to afford gas consumers the protection to which they are entitled under the Natural Gas Act. Under these circumstances, there is no basis for assuming that prices which "have leaped from one plateau to the higher levels of another" will constitute a level which will be "the lowest possible reasonable rate consistent with the maintenance of adequate service in the public interest." *Catco, supra,* at pages 391, 388.[19]

It is thus clear that our examination of the contract prices of the gas producers is only the beginning and not the end of our task in establishing the proper criteria for determining just and reasonable rates.

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RESERVES TO PRODUCTION RATIO AS A REGULATORY STANDARD

The producers contend that the gas supply situation is so critical that any significant limitation on contract prices would necessarily result in a dampening of essential exploration and development activity. In major part this argument resolves around the controversy as to the declining reserves to production ratio (R/P ratio) in the gas industry. This ratio has been as high as 32.5 to 1 in

[19] As the Supreme Court pointed out in the *Catco* case, *supra* (at p. 388, footnote 7), this "declaration of which stems from the original version of Section 7 of the Act, was not intended to be changed by the 1942 amendment to the Act, which omitted that provision.

1946 and it has steadily declined to about 18.7 to 1 in 1963, based upon the reserve figures provided by the American Gas Association and the American Petroleum Institute.[20]

The producers suggest that the reserves to production ratio should be the barometer by which the Commission is guided in setting any limitations upon the producers' contract prices and specifically that no such limitation should be imposed if the R/P ratio is not at least 20 to 1. Alternatively, they argue that, even if the Commission were to adopt the 17.5 to 1 ratio which the examiner believed was a reasonable target for 1970, present trends indicate that a lower ratio will be reached by that date; and they argue further that fixing area ceilings below existing contract prices would act as a brake on producer investment in gas exploration and development, and would therefore be contrary to the public interest.

In evaluating the producers' argument we must first analyze the forces which have determined the overall level of exploration and development by producers in the Permian basin and elsewhere. The overwhelming fact which emerges from this record is that the vast increase in exploration and development of gas supplies which has taken place in the last two decades has resulted from the development of a system of interstate pipelines which has created an ever increasing nationwide market for gas. In short, the producers have stepped up their

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[20] The 1964 statistics available after the record was closed revise the R/P ratio for 1963 to 19.0 to 1 and reveal that the ratio in 1964 was 18.3 to 1.

exploration and development activity because a market had been created for their product, even though during most of this period the prices have been far lower than fully allocated costs as determined herein.

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We agree with the examiner that the emergence of directionality, *i.e.*, the ability of producers to direct their drilling activities toward either oil or gas, brings into being for the first time an opportunity for price to play a significant role in increasing the supply of gas-well gas available to the interstate market. We have reflected this fact in the system of ceiling prices which we are adopting because, in our opinion, the true benefits of directionality can be best achieved through a two-price system which, though based on costs, by its very nature provides a special inducement for exploration for gas-well gas. Such a system should permit price to play its full role in eliciting needed gas supplies. To permit still higher prices would only create windfalls for the producers with no assurance of any concomitant consumer benefits.

We agree that a strong exploration program which will discover and develop gas reserves in ample time to meet the increasing demands of gas is vital. Any method of fixing just and reasonable prices must take this into account. However, there is no reason to assume that there is a direct relationship between any calculated R/P ratio and the price of gas. On the contrary, the R/P ratio went steadily down during the periods in

which gas prices were staging their most spectacular increases. It seems clear that even an exploratory program which will continue to add substantially more reserves annually than are produced is almost certain to fall short of preventing a further decline in R/P ratios.

As long ago as 1957, the AGA in *Gas Facts*, 1957 edition, page 6, stated that the industry should not be preoccupied with a "hypothetical" reserves to production ratio, but should focus its concern on finding sufficient gas to replace that consumed each year. There is considerable doubt that it is desirable, from the point of view of the public or the industry, to require or encourage a high level of proven reserves many years in advance of their probable use. It is an extremely costly matter to find and hold reserves beyond those which are needed to

assure ample supplies to consumers. The Commission's recent action in allowing exceptions to the 12-year minimum deliverability rule was a limited step in recognition of this fact.[21]

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[21] Order No. 279, 18 C.F.R. 2.61, 260.7; issued March 31, 1964, prescribing the filing of annual reports by pipelines to furnish information with respect to total gas supply and deliverability stated, "* * * information from the reports will make it possible to relax the Commission's 12-year deliverability life requirement where the information supplied by the pipeline company indicates it has an active procurement program, its system extends into production areas with continuous exploration and the results thereof indicate continuing ability to meet gas requirements."

There is also serious question as to the reliance to be placed on the available R/P ratio figures. The proven reserve figures are admittedly conservative. The amount of proven gas reserves added each year depends more upon revisions of former reserve estimates which have varied widely than upon new findings. The true ratio of reserves to production is undoubtedly higher at the present time than would appear from available statistics.

For all these reasons, we believe it would be doubtful wisdom for this Commission to attempt here to fix the minimum appropriate level of reserves for the industry, and particularly we think that it would be unwise as well as futile for us to attempt to gear our pricing policies towards maintaining a reserves to production ratio of 17.5 to 1 or higher. The ratio has already declined very close to that point, and it will probably decline further regardless of the price of gas set by this Commission. Such a decline is the inevitable result of increases in consumption on the scale that we have witnessed in the past decade. Under these circumstances, any attempt to maintain a specific ratio of reserves to production by permitting interstate prices to reach their maximum contract level would be much more likely to affect adversely the market for gas than to induce substantially greater supplies.

The impracticability for the long term of attempting to maintain indefinitely a 17.5 to 1 ratio may be demonstrated by some simple figures. It is estimated that by 1980 natural gas use, already more than 15 trillion cubic feet a year, will have grown to 25 or more trillion and by

the year 2,000 annual use can be expected to exceed 30 trillion. This level of use at the specified ratio would require reserves of 525 trillion cubic feet. By that date we shall have used some 900 trillion cubic feet of gas now in the ground, which would mean a total of some 1400 trillion cubic feet would have been found. This is in the middle of the range of responsible estimates of the total gas found and to be found in the United States.

That the reserves ratio will decline is not necessarily a cause for concern for many years to come. The high ratios of the past were not a result of design or of business prudence, but resulted rather from lack of a market for the immense reserves discovered in the search for oil. In such circumstances the imposing reserve ratios of the past have little significance. With the intensive post-war development of the natural gas market we are witnessing an adjustment of the reserve ratio to economic levels.

While the adequacy of reserves is an important factor in our determination here, and will continue to be an important factor in reviewing area rates in the future, we cannot accept the producers' position that the maintenance of a particular R/P ratio justifies the existing and future contract prices, whatever they may be.

THE TWO-PRICE SYSTEM

The presiding examiner at pages 12-38 of his opinion presents a persuasive discussion of the "Economic and

Institutional Factors Which Govern the Method of Establishing Area Rates."

The touchstone of the presiding examiner's decision is his conclusion that the industry is increasingly becoming able to direct its exploration efforts toward finding new gas-well gas as distinguished from finding gas as a by-product in the search for oil. This newly documented ability of the industry to channel its exploration investment toward either gas or oil serves as the basis for a pricing system, which we here adopt, that will make use of the economic drive of the industry in order to bring needed gas supplies to consumers at the lowest reasonable price.

The Commission's staff and some of the interveners argue that even if some companies can effectively direct their exploratory activities toward gas, it has not been shown that all of the Permian Basin producers can do so. In making this argument special reliance is placed upon testimony to the effect that small producers do not have the resources necessary for effective directional exploration.

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We have considered the evidence presented and we conclude, as did the examiner, that the larger producers in the industry have shown an increasing ability to direct their drilling activities toward either gas or oil, as they desire. Large producers maintain geological staffs and extensive files of geological information upon which the

necessary predictions can be based. While small producers, may lack the capital to maintain the organizations necessary for effective prediction, they often drill on lands obtained on farmouts from larger producers and thereby obtain the benefit of the geological knowledge required for directional drilling. To this extent it appears that even small producers are often able to drill with some assurance as to what they may expect to find.

In agreeing with the examiner's finding on directional drilling we do not mean to suggest that all exploration and development activity by producers is based upon reliable predictions as to what if anything will be found. What we do say is that on this record a major portion of the industry operating in the Permian Basin in recent years has demonstrated the ability by directional drilling to increase the known supply of gas, provided that the regulated price and the demand for gas justifies such an investment. Looking to the future we are establishing a pricing system that will encourage the industry to expand and perfect its ability to drill directionally so that revenues from gas consumers can increasingly be devoted to finding additional gas reserves.

In referring to the incentive provided by the ceiling for "new" gas-well gas we are not providing any special, isolated amount as a separately designated incentive. The inducement to be found in the "new" gas price is of an inherent nature and is not represented by any sum ear-marked for that purpose. The incentive is built into the two-price system. It provides a price for the future related to current and future costs and payable only to

producers who discover gas-well gas and dedicate their discoveries to the interstate market.

A single price based on an average of historical and current costs could not provide the same incentive to explore for gas in the future even if it yielded the same

revenue. A single price based on future costs will result in windfalls to those producers who acquired and sold gas under lower cost conditions. The two-price system thus holds out a reward to encourage producers to engage in further exploration and development while preventing excess and unnecessary revenues from the sale of gas developed at a period when there was no special exploratory activity directed to gas discovery.

The producers favor a single price and the arguments they make are aimed at obtaining the "new" gas price as the one price to be applied to all gas. We disagree. If a one-price system were to be adopted, average historical costs — not the higher current costs — would necessarily serve as its foundation, and we have no assurance that such a price would elicit the investments at current cost levels which are needed to bring forth adequate new supplies of gas-well gas.

The producers support a contention for a single price based on current costs with the argument that current revenues provide financial support for current exploration and development. Assuming *arguendo* the factual

basis for the argument, this is not an acceptable reason for "flowing gas"[22] being the beneficiary of "new" gas-well gas prices. The producers' inducement to engage in further exploration and development directed toward gas comes from the knowledge that future gas supplies will receive a price which provides adequate compensation. Of course the availability of funds to seek new sources of supply is a factor to be considered in the fixing of all prices, and we have not overlooked this factor in the determination of the "flowing" gas price. It does not follow that a single price for all gas is required. On the contrary, as already stated, if such a ceiling were fixed high enough to elicit new gas-well gas supplies it would result in windfall profits for all other gas and if fixed low enough to reflect costs for old gas it would not assure adequate supplies for the future.

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The record in this case was augmented by the econometric studies introduced by the staff and a rebuttal showing by the producers. These studies are, as the examiner stated, truly pioneering endeavors. The studies were not designed to support a specific rate recommendation or rate design but served to focus attention upon the important role of market demand among the considerations relevant to our decisions. The studies indicate that ad-

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[22] The term "flowing gas" in this opinion will be used to include old gas-well gas, oil-well gas and residue gas as explained in detail at pages 78-80, *infra*.

vanced statistical and mathematical techniques can be useful in understanding the interaction of the price of gas at the wellhead and the demand in the marketplace.

The econometric studies in this case were based on the assumption of a one-price system and as noted by the examiner, "on a non-directional hypothesis." The quantitative results of the studies therefore cannot be relied upon in this case although the studies tend to support our conclusion that a two-price system is necessary and desirable to make positive use of the interaction of price and gas supply.

It has been suggested that providing a separate ceiling for new gas-well gas may retard the search for gas by inhibiting demand, on the theory that high prices may price gas out of some markets. This argument may have some merit as an abstract proposition but it misses the mark when applied to the facts of this case. We are not here fixing a ceiling that will increase prices but rather one to reduce unreasonably high prices and stabilize field prices generally. Furthermore while fixing a higher ceiling for new gas-well gas (including residue gas derived therefrom) we are also fixing a lower ceiling for all other gas. Certainly the ceiling prices fixed herein which will stabilize gas prices that have been increasing in the past cannot be a basis for predicting a declining market.

Some who opposed the examiner's price structure also argue that no need to encourage a stepped-up search for additional reserves at this time has been shown. It is pointed out that on a nationwide basis the AGA figures on proven reserves show that more gas has been found each

year than was consumed, even though the reserve ratio as computed by AGA has been declining. It is also argued that we must take into account increasing discoveries of gas in Canada and Mexico as well as the possibility that technology may make new sources of energy available to supplement gas long before present reserves are exhausted.

It is beyond dispute that continuing exploration and development of new gas reserves is necessary in the public interest. The only question is the proper scale of the necessary effort. In the absence of a regulatory pattern which offers encouragement for the search for gas there is no guarantee that the present generally satisfactory pace of exploration will continue, much less increase to meet growing demands. New gas discoveries are the lifeblood of the industry and are also essential to consumers who are tied to natural gas. This Commission cannot discharge its responsibilities to the public by relying on unsupported suggestions that gas supplies from distant sources or other forms of energy will suffice to meet an obvious need for new gas supplies to serve the needs of the pipelines and of their consumers who are tied to the use of this fuel by large investments in gas utilization equipment.

In the past the greater part of the gas in the Permian Basin was found in the course of searching for oil but, as the examiner found, in recent years there has been a decline in drilling for oil. The future needs of the gas

market can no longer be satisfied by the incidental discoveries in the search for oil. Accordingly, there will be a greater dependence on exploring for gas wells to bring forth needed gas supplies in the future and this fact supports our conclusion to fix a higher ceiling for new gas-well gas which will encourage exploration at deeper horizons directed toward finding gas.

The separate price we fix herein for new gas-well gas in the Permian Basin should serve to furnish a practical test of whether in fact it will result in bringing forth additional supplies. In order to assure that every effort

will be made by producers to bring in new gas-well gas we also state our conviction that the ceiling set in this proceeding should continue to apply to all such new gas dedicated within the ceiling fixed herein even if in any later review of the area rate for the Permian Basin the evidence indicates that a lower price would be justified for future discoveries. We cannot bind the Commission for the future, but we state our view that any lower ceiling should apply only to new gas dedicated after the ceiling price may have been subsequently reduced.

On the basis of the record made in this proceeding and after careful consideration of the arguments against the examiner's findings on these points we conclude that there is substantial support for pricing new gas-well gas at a higher level in order to encourage the search for new gas reserves at minimum overall cost to consumers.

THE DATE OF DIVISION BETWEEN NEW GAS-WELL GAS AND OLD GAS-WELL GAS

The presiding examiner fixed December 23, 1960, the date this proceeding was initiated, as the date dividing new gas-well gas from old gas-well gas. Gas moving under contracts filed with the Commission before December 23, 1960, would be classified as old gas; gas moving under contracts filed on or after that date would be new gas. Staff has advocated a division date of January 1, 1961, which would offer the administrative convenience of making the division at the beginning of the calendar year. The California Distributors urge that the new gas price should be effective only as to gas moving under contracts filed after the conclusion of this proceeding. They argue that any incentive element included in a higher price for new gas can fulfill its purpose only with respect to gas dedicated to interstate commerce after the conclusion of this proceeding. The Major Producer Group, on the other hand, would apply the new gas price to all gas moving under contracts dated after June 7, 1954, the date when regulation of natural gas producers commenced.

The argument that a two-price system should have a 1954 breaking date is weak. The essential justification for the dual price system is that with the recent development of directionality there is for the first time a basis for believing that gas exploration and development activi-

ties may be responsive to price. To apply a price based upon the present cost of finding and developing gas-well gas to such gas (to say nothing of casinghead and residue gas derived therefrom) developed before the era of directionality would be inconsistent with the rationale of our decision and bestow a windfall on the producers.

There is more plausibility to intervener's argument that the cut-off date between new gas and old gas should be the effective date of this decision. We agree with the examiner, however, that the proper breaking point should be at or near the end of 1960. As indicated *infra,* our price for flowing gas including old gas-well gas is being fixed primarily on the historical cost-of-service for this case as derived from the respondents' cost data supplied in response to the Commission inquiry. The test year for such data is 1960. Moreover, while the new gas-well gas ceiling is based on current rather than historical costs, the record indicates that directionality upon which the two-price system is based first became significant about 1960, and that costs have remained constant since that time.

There is another reason why we believe that a date approximating that fixed by the examiner is in the public interest. In effect, the two-price system which we have now prescribed was established for Permian and many other pricing areas in the adoption of our dual guideline ceilings by the September 28, 1960, Statement of Policy. Our pricing policy has given different treatment to gas dedicated since that date than to older gas. The expectations of producers which would presumably result from

this policy of the Commission are thus consistent with the cost of considerations referred to above.

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The specific date for distinguishing between old and new gas-well gas presents, we believe, primarily an administrative problem. The examiner suggested December 23, 1960, the date of the institution of the Permian proceeding, but this would imply that the old gas/new gas breaking point in the various areas should depend upon when the particular area case was initiated — a date which has no necessary relationship to any of the considerations referred to above. It has been suggested that the September 28, 1960, date on which we issued the Phillips decision and the statement of policy should be utilized. However, our decision therein could hardly have had any such instant effect upon contract negotiations, to say, nothing of the effect upon exploratory activity. Moreover, using September 28, 1960, as the dividing point would mean that some of the gas sold in the test year and used for determining old gas mixes would receive new gas treatment. We think that, all things considered, it would make more sense to set the dividing line as of the end of the 1960 test year. Accordingly, the new gas ceiling will be made effective for contracts entered into on or after January 1, 1961.

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BASIC STANDARD FOR NEW GAS-WELL GAS CEILING PRICE

It becomes necessary at this point to define gas-well gas with more particularity. By gas-well gas we mean so-called nonassociated gas, that is, gas from dry gas reservoirs and gas condensate reservoirs, and gas from gas-cap wells.[23] Within these definitions the classification of gas wells by the appropriate state agency will be accepted for purposes of this decision in the absence of a showing that it is not a reasonable classification for pricing purposes. The definition of all other gas will be discussed *infra* at pages 70 and 75.

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Except for those parties who advocate existing contract prices as the primary regulatory standard, all parties recognize that costs must be a major factor in determining the area price. If the area rate approach is to rest on a solid foundation there must be an objective test by which the industry, the consumers and the courts can appraise the fairness of the price we fix. We are convinced that a composite cost determination is the bedrock on which a regulated price must be established. The issue

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[23] Gas-cap gas is a special category of gas from an oil reservoir that can be produced free from the influence of oil production. As a practical matter state classification of the small amount of gas in this category in the Permian Basin makes it reasonable to include gas-cap gas in the category of gas-well gas. If production of gas-cap is governed by allowables set for oil by the state agency, it will not be considered gas-well gas.

is thus narrowed to one of the weight to be given cost evidence and the particular cost-finding technique we are here to adopt.

The Supreme Court in the second *Phillips* case, in upholding the Commission's abandonment of individual company cost-of-service and sanctioning the Commission's efforts to proceed with the area rate approach, observed with approval that the Commission had stated that area rates would be based on the " 'reasonable financial requirements of the industry' in each production area" and that "composite cost of service data will be considered in the area rate proceedings." (376 U.S. at 310)

Accordingly, we conclude that composite cost showing must be the basic ingredient in determining the area rate. This does not mean that other factors should not be considered. The Commission must exercise its judgment and determine a rate in light of all the evidence in the record. For one thing, the rate must be one that the evidence indicates will elicit a level of exploration activity adequate to provide the increased gas supplies required by consumers in the future. There is also a need to exercise judgment in the design of the rates to avoid unnecessarily sharp and abrupt departures from existing pricing patterns and the business and community dislocations which could result. Of course, in fixing the rate of return, a key element in the cost of determination, the Commission has wide discretion to consider these factors, so that to a considerable degree they can be accommodated within the framework of composite cost pricing. Nevertheless,

we make clear that we do not confine ourselves to a cost calculation in determining just and reasonable rates.

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Basic to our determination of the guidelines for the price of new gas-well gas is the selection of the method of cost finding to be adopted. We shall discuss later in this opinion the cost basis for all other gas but it may be helpful here to say that we shall use the cost of gas-well gas as the yardstick for all prices we fix in this proceeding. We do so for two reasons. First, the record reveals that casinghead gas and other associated gas are found largely as a by-product of the search for oil. Historically, casinghead gas has not been priced on a cost basis and any cost-finding technique is unrealistic which assigns large sums for exploration and development to casinghead gas. A second and related reason is that gas-well gas costs are much more meaningful because they are far less dependent upon allocations between gas and oil than are the costs of casinghead and other associated gas.

The parties suggested three basically different methods for determining the cost of new gas-well gas. The main producer presentation is an estimate of the cost of financing new supplies of gas-well gas on an industry basis in which all exploration and development (E&D) expenses are capitalized and a discount rate of return utilized. The California Distributors also presented a gas-well gas cost study based on published national statistics and the answers by respondent producers to

the Commission's cost questionnaire but instead of capitalizing E&D cost, expensed them, and utilized a conventional rate of return. Both methods provide a nationwide cost for gas-well gas keyed to the cost of finding and producing new gas supplies. The third cost approach, presented by the Commission's staff, is a composite presentation patterned after the individual company cost-of-service approach in which there is determined the historical cost per Mcf of gas-well gas production. The staff also presented a similar composite presentation limited to Permian Basin area costs.

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A preliminary question in determining the methodology of cost finding is whether costs are to be determined on an area or a national basis. As the examiner pointed out, the question is not whether a national price should be established but whether national or area costs should be used as the basic standard for fixing the future price of new gas-well gas in the Permian Basin. All parties agree that exploration and development operations are conducted by the industry on a national basis because it is impossible to isolate E&D by areas. Without adopting all of the reasons advanced by the examiner at pages 40 and 41 of his opinion we agree with the conclusion that the cost of new gas-well gas should be determined on a national basis. Perhaps most persuasive is the fact that we are fixing a price based upon current cost of finding an Mcf of gas and that much, if not most, of the rele-

vant information is available only on a national basis. It may be that in some areas production costs may vary sufficiently from the national average to warrant a different treatment but on the record in this case we agree that cost of new gas-well gas should be determined on the basis of nationwide data.

The examiner adopted, with modifications, the cost presentation of the California Distributors. We agree with the examiner that in determining a ceiling for new gas-well gas which is to serve as an incentive to search for additional gas the preferable approach is the one that is geared to the recent cost of finding and producing an Mcf of gas rather than the historical cost based on production volumes. Historical costs will not necessarily reflect current realities.

A price based on the current cost of finding and producing an Mcf of gas-well gas, on the other hand, should provide the economic incentives to find and sell gas under prevailing conditions at rates which are keyed to industry needs and at the same time protect the interest of consumers.

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We believe that the method of costing we have adopted in this proceeding is required on the basis of the record before use and that it provides a sound basis for our decision. We emphasize, however, that our conclusions herein should not be construed as necessarily constituting the final solution of this intricate problem. Other methods

of estimating the new gas cost may be given further consideration in succeeding cases if adequately supported.

THE COST OF NEW GAS-WELL GAS

We shall now proceed with an examination of the presiding examiner's determination of the cost of new gas, and of the exceptions thereto, in our determination of the area price ceiling of new gas-well gas.

A word of explanation is in order as to the variety of data sources utilized for determining the cost of gas in this proceeding. The natural gas producers, unlike electric power companies and natural gas pipelines, have not as yet been required to conform their books to a uniform system of accounts. The petroleum producers typically do not reveal their cost experience or accounting treatment in depth. When this proceeding was initiated there were no statistics available based on a uniform set of accounts to provide the necessary information for making the cost determinations in this proceeding. The cost questionnaire promulgated by the Commission was designed to fill this information gap in part and the responses have supplied a vital source of information for determining costs in this proceeding. In addition Census data and other well-recognized and authoritative industry data sources were utilized by various witnesses in the proceeding. The record is thus built upon a variety of sources which we believe in combination provide an adequate basis for the costs we have found.

The presiding examiner found that the national average cost of an Mcf of new gas-well gas was 16.88 cents. His

computation and our modifications thereof may be summarized as follows:

	Cost in Cents per Mcf	
	Examiner	Commission
Exploration and Development Costs		
Dry Holes	1.42	1.42
Other Exploratory Costs	1.59	1.59
Adjustment for Exploration in Excess of Production	1.11	1.11
Production Operating Expense	2.88	2.70
Net Liquid Credit	(2.68)	(3.10)
Regulatory Expense	.14	.14
Depletion, Depreciation, and Amortization of Production Investment Costs		
Successful Well Costs	2.88	2.88
Lease Acquisition Costs	.76	.76
Cost of Other Production Facilities	.31	.31
Return on Production Investment (at 12 percent)	5.21	5.21
Return on Working Capital	.20	.35
Subtotal	13.82	13.37
Royalty at 12½ percent	2.11	2.05
Production Taxes[24]	.95	1.01
Total	16.88	16.43

[24] Texas production taxes of 7 percent have been used in the Commission's computation. New Mexico taxes are lower, and both cost computations and the ceiling price should be reduced accordingly for gas produced in New Mexico. The amount of production taxes does not include taxes on the royalty payments which are chargeable to the royalty owner.

EXPLORATION AND DEVELOPMENT COSTS

Dry Hole Costs

Adopting the California Distributors' presentation, the presiding examiner derived a dry hole cost of 1.42 cents per Mcf principally on the basis of data published by the United States Bureau of Census, Census of Mineral Industries for 1958 (1958 Census), with respect to drilling costs per foot. Since there were no such census costs available for 1960, he established a trend for such costs by comparing 1958 and 1960 cost data obtained, in response to the questionnaire circulated by this Commission, from producers of more than 10 million Mcf annually, producing in the Permian Basin.[25] He then adjusted the 1958 Census figures in accordance with the trend established from the questionnaire data to establish the 1960 costs.

The Major Producer Group objects to the examiner's use of questionnaire data to establish a trend in E&D cost from 1958 to 1960 and adjusting the 1958 Census figures on the basis of the trend established. We think the examiner was correct in determining that the questionnaire data are valid for purposes of establishing a trend in the entire industry. We adopt the reasoning of

[25] The questionnaire data includes costs from a few producers of less than 10,000,000 Mcf annually who also responded to the questionnaire. However, the inclusion of this data does not affect the results.

the initial decision upon this point, and the 1.42 cents per Mcf cost, as set forth in Appendix B, pages 1 and 2.

As we have already noted, other methods of computing dry hole costs were suggested in the record. Of particular interest in the alternative method of cost determination, advocated by the Major Producer Group, often called the project method, which capitalizes the total cash outlays to acquire a capital asset (*i.e.*, project) and allows a return on that investment over its productive life. Under this method, dry hole costs and other costs associated with unproductive ventures would be capitalized along with the cost of productive ventures. We find that this alternative method which would constitute a departure from our treatment of E&D in prior proceedings as well as a deparure from present industry accounting practices is not adequately supported in the record. The inadequacy is especially

notable with respect to the cost of capital for establishing the fair rate of return to be allowed on the computed investment base. However, capitalization of E&D may well be a useful approach and we do not foreclose in succeeding cases further consideration of this alternative method of costing or of improvements in the cost-finding techniques herein employed.

Other Exploratory Costs

In a category for exploratory costs other than dry holes, the examiner included geological and geophysical

expenses, lease rentals, and exploratory overhead. These costs were the subject of testimony by Witness Roseman for the California Distributors and Witness Park for Texaco, Inc. Roseman estimated the cost of geological and geophysical expenses and lease rentals on the basis of their relationship to lease acquisition costs as shown by the Chase Manhattan Bank's Annual Analysis of the Petroleum Industry for 1961. Since the purpose and result of the outlays for geological and geophysical activities and lease rentals is the purchase of leases, there is a direct relationship involved. The Chase survey shows that geological and geophysical expenses and lease rentals average 138 percent of lease acquisition costs in the period 1957 through 1960, the same period Roseman used in computing lease acquisition costs. Having determined that the lease acquisition costs for that period were 0.76 cent per Mcf (see pp. 51-52), Roseman accordingly computed the geological, geophysical, and lease rental costs at 1.05 cents per Mcf.

Exploratory and developmental overhead were calculated by Roseman on the basis of their relationship to total finding and developmental costs. The 1958 Joint Association Survey, the only published source of such data, established overhead costs as being 8.4 percent of total finding and development costs, or 0.54 cent per Mcf. (Total finding and developmental costs were 6.42 cents per Mcf, this being the total of 1.05 cents for geological and geophysical expenses and lease rentals, 1.42 cents for dry holes, 2.88 cents for successful well costs, 0.76 cent for lease acquisition costs, and 0.31 cent for cost of

other production facilities.) Adding 0.54 to the 1.05 cents per Mcf costs for geological, geophysical, and lease rental costs, results in a total of 1.59 cents for the category of Other Exploratory Costs.

Witness Park used a different method. He combined geological and geophysical expenses, lease rentals, and overhead into a single item. He then found that the ratio of this item to dry hole exploratory expense, based on the Joint Association Survey, was 1 to 1. His result is 1.56 cents.

We believe that Witness Roseman's approach which computes each of these items of cost on the basis of comparisons with items to which they are functionally related is preferable. In any event the difference between the two witnesses is *de minimis* and no exceptions were taken to the examiner's determination of 1.59 cents per Mcf based upon Roseman's testimony. We therefore adopt the examiner's finding as supported in the accord.

ADJUSTMENT FOR EXPLORATION IN EXCESS OF CURRENT PRODUCTION

The record establishes that additions to proved reserves of natural gas in the United States have exceeded production in each year. We believe it essential to encourage a level of exploratory effort which will continue to provide for findings in excess of production. Since

exploration and development losses are expensed by the industry in the year incurred, and are so treated here (but see our discussion of the possible use in the future of the project method, pp. 41-42), the allowance for such losses should be recouped from production during that year. The total cost of finding the necessary volumes of gas must be translated into an allowance per Mcf of gas produced so as to bring in the necessary revenues. To this end a conversion factor is necessary to adjust the per Mcf cost of unsuccessful E&D efforts from the volume of reserves discovered to the volume of gas produced during the year.

The ratio of findings to production vary from year to year. These ratios for gas-well gas were 122 percent in 160, 155 percent in 1961, 180 percent in 1962 and 122 percent in 1963, while the weighted average of findings of all gas was 127 percent of production for the years 1960 through 1964. The appropriate ratio for these purposes is a matter for careful judgment rather than scientific formula.

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We recognize that what the industry has been spending is not necessarily the desirable expenditure in the public interest. We believe, however, that the level of recent expenditures represents an appropriate basis for determining the ratio which should be adopted. In applying judgment we conclude that the ratios for gas-well gas are the more significant, but they must be discounted in view

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of atypical result 1962. If the 1962 figure is brought down to the level for 1961, the four-year average becomes 138 percent. These figures point to an adjustment figure in the range of 35 to 40 percent. In these circumstances we shall utilize the 37 percent figure adopted by the examiner with which all parties have concurred. We believe such a ratio provides a necessary adjustment of the allowance for E&D for new gas-well gas to permit a level of findings reasonably in excess of production. Applying this ratio to the 3.01 cents per Mcf for E&D results in an additional 1.11 cents per Mcf allowance.

The examiner reached a similar result although he associated his allowance, which he termed an "allowance for growth", with a precise reserve-production ratio for the future, a rationale which we cannot accept. However as we have explained, we are satisfied that his conversion factor approximately represents the recent history of findings and is an appropriate conversion factor to permit the recovery of the cost of exploration and development during the year incurred.

The Major Producer Group's exception on this point, which is based on a contention that the ratio of reserves to production should be increased to 20 to 1, is denied. See *supra*, pp. 25-28.

Summary of Exploration and Development Costs

The exploration and development allowance which we here provide as a component of the cost of new gas-well gas will permit the industry to recoup from current pro-

duction all costs presently being incurred in a satisfactory level of exploratory effort. In effect we have found that the industry is now spending approximately 4.12¢/Mcf for exploration and development computed on the basis of the total production of new gas-well gas. Our allowance for E&D provides the industry with the funds to continue the same ratio of E&D in relation to volumes produced.

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PRODUCTION OPERATING EXPENSE

On the basis of testimony by Witness Roseman on behalf of the California Distributors, the examiner found that a cost of 2.88 cents per Mcf was proper for production operating expense. Witness Park, presented on behalf of Texaco Inc., testified that the amount should be 2.62 cents per Mcf, or 0.26 cent lower. Both Park and Roseman derived their figures from the data on nationwide production costs received by this Commission in response to the questionnaire circulated to Permian Basin producers.

The basic differences between Roseman's and Park's results are two-fold. The first is that in the allocation of overhead expenses Roseman used direct lease cost and expenses, including depletion, depreciation and amortization (DD&A). Park, on the other hand, used direct lease costs and expenses, but excluded DD&A. We find that Park's exclusion of DD&A was proper for the reasons

set forth in discussing this issue in connection with flowing gas in Appendix C, page 3.

The second difference is that Roseman made an adjustment of the production operating cost to reflect national production of condensate and gas, rather than relying strictly on the questionnaire data for production of condensate and gas. His justification for such adjustment, which the examiner adopted, was that the respondents filing questionnaire data produced a disproportionately large amount of lease condensate in relation to their gas production. (They produce one-half of the national lease condensate but only one-third of the national gas-well gas.) Park did not make such an adjustment. We agree with Roseman that this adjustment should be made because of the disproportionate production of condensate. We adopt Roseman's production operation expense allowance but modify it to reflect the proper overhead allocation. Making this modification, the production operating cost is 2.70 cents per Mcf.

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ADJUSTMENT OF NET PRODUCTION TO MARKETED PRODUCTION

The examiner included no special item in his cost computation to reflect the costs of gas produced but not sold. Witness Park included a 5-percent adjustment which he said was to compensate for waste, for venting, and for gas consumed on the producing property. The

Major Producer Group contends that there should be at least a 2-percent adjustment. The annual reports of the Texas Railroad Commission and the Louisiana State Conservation Commission for 1960 show that in these states, which produce 75 percent of the nation's gas-well gas, less than one-tenth of one percent of the gas was vented and wasted.

We agree with the examiner for the reasons stated at pages 85-86 of his opinion that there is no justification for making any allowance for the negligible amount of gas vented or wasted.

NET LIQUID CREDIT

When gas is produced some of the entrained liquids may condense while the gas is being lifted or shortly thereafter, and some of the liquids may be extracted by processing operations. The producers often receive substantial revenues from the sale of the liquids independently of the price they receive upon sale of the gas, and such liquids are an important item of commerce. Witness Roseman, on behalf of California Distributors, and Witness Park, on behalf ofTexaco Inc., both credited the revenues received by gas producers from the liquids contained in the gas to the cost of finding and producing the gas. The Major Producer Group now contends that no liquid credit should be adopted. Staff, on the other hand, has excepted to the examiner's determination that the proper amount of the liquid credit is 2.68 cents per Mcf, net, after royalties and production taxes are deducted, and contends that the proper amount for new gas-well gas is 3.27 cents per Mcf.

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As to the basic issue whether it is appropriate to credit the cost of gas with the liquid revenues, we adopt the examiner's views as follows:

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> The logic of crediting the revenues from the liquids is that the producer can reasonably expect that, from a proposed expenditure in the generally directional search for and production of gas-well gas, he will receive revenue from the liquids as well as from the gas. Thus he may count against his prospective total cost the expected revenues from the liquids. The remainder represents the revenues to be derived from the gas if the total costs are to be met, and is the cost burden that has to be borne by the gas. Since the price of lease condensate has been relatively stable in recent years[11] and since the credit amounts to only sixteen percent of the price for new gas-well gas adopted herein, it is not likely that changes in the price of condensate will produce significant swings in the price of gas. In these circumstances, crediting the liquids is reasonable for the purpose used here. (Initial Decision, Appendix, B, pp. 88-89.)

The producers' argument to the contrary is essentially that since the Commission does not regulate the sale of

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[11] Average prices for lease condensate were: 1954, $3.01 per barrel Census; 1958 $3.05, Census; 1960 $3.03, Appendix B.

liquids it is improper to credit revenues. This is equivalent to saying that oil-well gas should be priced at the total cost for both oil and gas because we do not regulate oil prices. The argument has been rejected by the courts with respect to crediting of liquid revenues extracted by pipelines.[26]

Witness Roseman's testimony and the presiding examiner's determination as to the amount of the liquid credit were based upon published statistics of the American Petroleum Institute (API) and the *Oil and Gas Journal*. The gross credit is derived by multiplying the condensate production from gas-well gas by the price received for the liquids and dividing this amount by the total gas-well gas production for the year in question. Using the *Oil and Gas Journal* production figures, the examiner concluded that 3 cents per Mcf is a reasonable estimate for the gross lease liquids credit from which he deducted royalty of 12.5 percent and production tax to obtain a net credit of 2.48 cents, exclusive of plant liquids revenue which we shall treat separately.

All of the statistical series point to the conclusion that there has been an increase in condensate production from gas-well gas since 1960, a rate of increase which is greater than the rate of increase in finding and producing gas

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[26] *Panhandle Eastern Pipe Line Co.* v. *FPC*, 324 U.S. 635, 646 (1945; *Cities Service Gas Co.* v. *FPC*, 155 F.2d 694, 703 (CA 10, 1946); *Panhandle Eastern Pipe Line Co.* v. *FPC*, 305 F.2d 763, 767-768 (CADC, 196...), *cert. denied*, 372 U.S. 916.

Summary of the Cost of Flowing Gas

The cost of old gas-well gas may therefore be summarized in accordance with the evidence presented by Staff and the discussion above as follows:[40]

[40] There is no separate item for royalty payments because costs were computed on the basis of ⅞ of the actual volumes and the royalty payments were thus included as an integral part of the cost-of-service computations.

Production	9.16
Exploration and Development	4.08
Regulatory expense (see p.)	.14
	13.38
State production tax @ 7%	1.01
Total	14.39

COMPARISON WITH EXAMINER'S COMPUTATION OF COST OF OLD GAS-WELL GAS

As we noted at the outset we place primary reliance on the historical test-year cost of service presentation. However, the examiner's method of computing the cost of old gas-well gas, with the revisions we think necessary, serves as a useful check on the results. It yields a cost closely comparable to that derived from the more traditional cost-of-service approach.

The examiner found that the cost of old gas-well gas should be fixed at the average cost of gas-well gas

produced in 1960. Gas produced in 1960 resulted from exploration and development conducted in some cases many years before, and the cost of drilling and equipping wells which produced gas

in 1960 was incurred in years ranging over a span of two decades. Accordingly, the examiner adjusted his exploration and development costs to reflect the lower cost in earlier years.[41]

We think that the procedure used by the examiner to arrive at his old gas-well gas cost is reasonable but that certain items of his computation require revision.

The examiner found that total exploration and development costs for old gas (dry-hole costs, other exploration and development expenses, and allowance for growth) should be 25 percent below the figure of 4.12 cents per Mcf applicable in the case of new gas-well gas.

[41] In view of the impracticability of determining such costs directly, the examiner used the following procedure, outlined in Appendix C to the initial decision: "The purpose of this analysis is to compare the average finding cost of old gas well gas (the gas produced in 1960) with the cost of finding new gas well gas (the reserve additions found in 1960). The general procedure follows these main steps: (1) the total volume of gas well gas produced in 1960 is distributed by estimated year of discovery; (2) the volume associated with each year of discovery is weighted by an index of drilling cost per MCF for that year (1960=100); and (3) the results are totaled and then divided by 1960 production, thereby deriving a weighted average finding cost for the gas produced in 1960 relative to the finding cost of gas well gas found in 1960. The basic data for this analysis consists of: (1) production of gas well gas reserves; (2) estimates of annual additions to gas reserves; and (3) indices of annual drilling costs per Mcf of reserves added."

This discount yielded a figure of 3.09 cents per Mcf for exploration and development. Production investment costs, DD&A and return, were similarly discounted 25 percent from the 3.95 cents and the 5.21 cents, respectively, applicable in the case of new gas-well gas, yielding a DD&A of 2.96 cents per Mcf and a production investment return of 3.91 cents per Mcf applicable to old gas-well gas.

Unlike production investment costs, exploration and development costs are not capitalized in our decision in this proceeding. They are expenses to be recouped by a producer in the year in which they are incurred. The fact that a lower original investment was necessary to

produce gas flowing in 1960 does not affect the exploration and development expenses incurred in that year. Accordingly, these costs should not be discounted, but should be the same as those included in the computation of the cost of new gas-well gas. We shall therefore allow the same amount for E & D as we permitted in the price of new gas-well gas.

In computing the production investment for old gas-well gas staff contends that it should be 84 percent of the new gas-well gas investment cost rather than 75 percent as a result of two revisions of the examiner's method. Staff accepted the examiner's method of deriving the cost of flowing gas-well gas; however, it proposed an 84 percent rather than a 75 percent discount factor as a result of two revisions of the examiner's method.

Staff's first revision of the examiner's approach was a technical adjustment of the annual index of drilling and equipping costs per Mcf added. The examiner's index measures the trend of the allocated cost of total gas reserves added (gas-well gas and oil-well gas), whereas Staff's index measured a trend of unallocated gas-well costs per Mcf of gas-well gas only reserves added. Since we are deriving a gas-well gas cost it appears that Staff's index is preferable to the examiner's index. Staff has utilized an index which produces a result approximately the same as the examiner's but avoids many of the complicated allocations. Accordingly, we will use Staff's index of drilling and equipping costs.

Staff's second revision of the examiner's backtrend method was to apply its national drilling and equipping cost trend to the vintage mix of jurisdictional gas-well gas produced in the Permian Basin rather than applying the cost trend to the vintage mix of all flowing gas-well gas on a nationwide basis, as was done by the examiner. We have determined that the ceiling price for flowing gas-well gas should be fixed primarily on historical costs in the area (*supra*, 78-79, 80-81). Therefore, the gas-well gas cost trend should be applied to the vintages of gas-well gas in the area.

These adjustments result in a figure of 3.32 cents for DD&A and 4.38 cents for return on production investment rather than the 2.96 cents and 3.91 cents, respectively, used by the examiner.

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With respect to all other items we shall follow the examiner's technique and use the same items of cost as used in the new gas-well gas computation. With respect to the amount for net liquid credit a word of explanation may be in order. The Commission concluded that the net liquid credit should be 3.10 cents per Mcf, rather than 2.68 cents per Mcf as allowed by the examiner. The Commission based its determination primarily on questionnaire data but in our discussion we pointed to the trend in recent years toward increased realization of condensate per Mcf of gas. The trend for the future has limited application to the liquid credit for flowing gas, but we do not rely on this factor and it is not material to our conclusion. The liquid credit we used for new gas-well gas is primarily based upon the questionnaire data which reflects the historical experience of condensate production. The figure we adopted is lower than the amount that could be justified by the latest statistics showing condensate production from the recent discoveries, especially those at greater depths. We believe that our allowance for liquid credit conservatively reflects the condensate derived from the flowing gas-well gas the costs of which we are attempting to verify.

The examiner's computation of the cost of old gas-well gas and our modification of his computation of course reflect the net differences in numerous other items previously discussed in our determination of a new gas-well gas price. A complete comparative summary follows.

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	Cost in Cents per Mcf	
	Examiner	Commission
Exploration and Development Costs		
Dry Holes	1.07	1.42
Other Exploratory Costs	1.19	1.59
Allowance for Growth	.83	1.11
Production Operating Expense	2.88	2.70
Net Liquid Credit	(2.68)	(3.10)
Regulatory Expense	.14	.14
Depletion, Depreciation, and Amortization of Production Investment Costs		
Successful Well Costs	2.16	2.42
Lease Acquisition Costs	.57	.64
Cost of Other Production Facilities	.23	.26
Return on Production Investment (at 12%)	3.91	4.38
Return on Working Capital	.20	.35
Subtotal	10.50	11.91
Royalty at 12½%	1.60	1.83
Production Taxes[42]	.72	.90
Total	12.82	14.64

[42] Texas production taxes of 7 percent have been used in this computation. New Mexico taxes are lower, and both cost computations and the ceiling price should be reduced accordingly for gas produced in New Mexico. The amount of production taxes does not include taxes on the royalty payments which are chargeable to the royalty owner. The results however are identical to the alternative method summarized at page 89 in which royalty payments were computed as an integral part of the cost of service and the separate item for production taxes was somewhat higher because it included taxes chargeable to the royalty owner.

It is apparent that the results obtained by using the examiner's method, as adjusted in the light of the Commission's views on liquid credit, return and other items, conform very closely with the results obtained in the Commission's own historical cost computation.

THE PRICE OF FLOWING GAS

On the basis of an historical cost determination, as verified by the examiner's approach, we shall fix a ceiling price for flowing gas rounded off at 14.5 cents per Mcf at 14.65 psia for gas produced and sold in Texas. The ceiling price in Texas includes a 1.01 cent production tax, which we round off to 1.0 cent, leaving a rate less production taxes of 13.5 cents. For gas produced and sold in the three New Mexico counties, Chavez, Lea and Eddy, the ceiling price shall therefore be 13.5 cents per Mcf at 14.65 psia plus the applicable production taxes in effect as of the date of this opinion. In accordance with the earlier discussion, this ceiling price will apply to all casinghead gas, and residue derived therefrom, both old and new, as well as to old gas-well gas and residue gas derived therefrom.

PRICE ADJUSTMENTS TO REFLECT QUALITY DIFFERENTIALS

The importance of quality standards as an integral part of our ceiling price becomes readily apparent if it is recognized that gas is purchased for its energy. The

price of gas cannot be related to volume alone but must be related to units of energy free of impurities and sufficiently compressed to enter the pipeline if it is to serve as a mechanism to assure just and reasonable rates. The presiding examiner pointed up the importance of relating the quality of gas to its price as follows:

> * * * Lowering the quality of the gas is the same as raising its price. If the pipeline purchases gas of lesser quality than previously, bears the cost of additional processing to raise the gas to its former standard, and includes the added costs in its cost of service, the result is the same as if the prices charged for the gas by the producer were raised. A pricing system that fails to insure quality and value is a sieve. [p. 67]

Some of the respondents have urged that no specific price differentials be established to reflect variations in quality. They argue that buyer and seller, after a ceiling price is fixed, will establish lower prices for gas of below standard quality by bargaining.

If we accepted the producers' contention, the burden of securing lower prices to reflect lower quality gas would be on the pipeline, and the record does not support the producers' contention that through bargaining the parties would necessarily agree upon prices for gas with quality deficiencies which were below the ceilings imposed for pipeline quality gas. A large loophole for evasion of

ceiling prices would lie open; a producer receiving the ceiling price for inferior quality gas would be piercing the ceiling prices, insofar as the consuming public is concerned, just as much as if the producer were collecting

an above-ceiling price for pipeline quality gas or deliberately diluting the gas with inert material. In addition, gas now flowing under existing contracts would not be repriced, whatever bargains might be made for the future. Its price would be governed by the existing contract terms, limited only by the applicable area price ceilings. We think, therefore, that in this proceeding we must require the area ceiling prices for new gas-well gas as well as flowing gas to be adjusted for departures from the standards for gas of pipeline quality. We believe that the record in this case provides an ample basis for the quality guidelines we here establish.

A preliminary question is the basis upon which the quality adjustments should be applied. We think these price differences should be predicated upon differences in the quality of gas sold under particular contracts rather than upon an averaging process. Such an approach is fairer to the individual producers, and avoids the possibilities of manipulation which would be inherent in a price system which failed to reflect quality differences in particular transactions.

Quality Standards

The first step in establishing price variations corresponding to variations in the quality of gas is to determine the quality standards which must be met if gas is to command the ceiling price applicable to its particular category. There are several quality factors which require consideration in establishing prices in the Permian Basin and we shall discuss each of them separately.

Sulphur

Sulphur, hydrogen sulphide, and other sulphur compounds are the most prevalent impurities in gas in the Permian Basin. The problem is greater here than in any other area in the country. The generally accepted standard in the Permian Basin, which we here adopt is that gas

which contains more than 10 grains of hydrogen sulphide or 200 grains of total sulphur per Mcf is designated as "sour gas" and is not considered to be of pipeline quality.[43] Gas containing 10 or less grains of hydrogen sulphide and 200 or less grains of total sulphur is known as "sweet gas" and is considered to be of acceptable pipeline quality in this respect. These standards are not only generally accepted in the Permian Basin, but it does not

[43] Total sulphur shall be determined as provided in: "Test for Total Sulphur in Fuel Gases" ASTM Designation: D 1072-56, adopted 1956.

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appear that any different standard with respect to sweet and sour gas is applied in other areas.[44]

Water

The record establishes that an accepted standard for pipeline quality gas in the Permian Basin is that the gas shall not contain in the aggregate more than 0.009 pound per Mcf of water, either in the form of liquid or vapor.[45] The prevailing national standard appears to be that gas should contain no more than 0.007 pound of water per Mcf of gas. Even more stringent standards appear in some of the contracts for sale of gas in the Permian Basin.

It may be argued that, since the national average cost has been used in arriving at the ceiling price for new gas-well gas fixed in this proceeding, the national standard for such gas should apply rather than an area standard. Until such time as this Commission has by rule established a different standard, we prefer to adhere to the accepted practices of the industry in the area and we shall consider gas in the Permian Basin containing not more than 0.009 pound of water per Mcf to be of pipeline quality.

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[44] We are cognizant of the slightly more liberal definition of sweet gas used by the State of Texas.

[45] Water vapor content is to be determined as provided in: "Test for Water Vapor Content of Gaseous Fuels By Measurement of Dew-Point Temperature". ASTM Designation: D 1142-58, adopted 1953, revised 1958.

Carbon Dioxide

Carbon dioxide is found in excessive quantities, sometimes as much as half of total volume, in 2 to 3 percent of the gas produced in the Permian Basin. It is not combustible and so has no value as fuel. Under the present technology, it contributes nothing in the way of liquids and is valueless to the petrochemical industry. It is not merely a diluent which reduces the value of the gas in proportion to the extent that it is present; it combines with H_2O to form a comparatively mild acid which has a corrosive effect on pipelines. When present in large quantities, its removal is required before the remaining gas can be considered to be of standard pipeline quality, and extraction may be costly.

The evidence in the record indicates that where carbon dioxide is a problem in the Permian Basin, it comprises over 5 percent of the volume of the gas. However any amount of carbon dioxide reduces the value of the gas and we believe that the presence of more than 3 percent of useless diluent in the gas sold to a pipeline would require a reduction in the price. Accordingly, for the purpose of this proceeding, a standard for pipeline quality gas shall be that carbon dioxide shall not exceed 3 percent by volume.

Other Impurities

There was no testimony in the record with respect to impurities other than carbon dioxide, water, sulphur,

hydrogen sulphide, and other sulphur compounds. Some filed contracts contain clauses requiring the gas sold under them to be free of oxygen, dust, dirt, gums, and other substances. Precise standards cannot be established with respect to these impurities. The only standard which may fairly be applied, on the basis of this record, is that such impurities will be considered excessive to the point requiring a reduction in the price of the gas if they are present in sufficient amounts so that a pipeline incurs processing costs to remove them from the gas.

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Btu Content

The record in this case reveals that in the past the level of Btu content (other than loss of Btu's resulting from excessive carbon dioxide content) has not been a substantial problem in the Permian Basin. Contracts for sales of gas in the Permian Basin generally contain clauses specifying that the Btu content of the gas sold shall not be less than a minimum, generally 1,000 Btu's; and little gas below that level (other than gas containing substantial amounts of carbon dioxide) has been sold in the Permian Basin. Any attempts to evade the ceiling prices for flowing gas imposed herein by reducing the Btu content of the gas below current standards in the area will come to our attention and many be dealt with as the occasion demands. Under these circumstances we see no need to establish any standard Btu

content for flowing gas in the Permian Basin so long as present conditions continue.

Looking to the future, however, we believe that it is important that we implement the general principle that Btu adjustment provisions "are in the public interest", advanced in our recent decision in Texaco, Inc., Opinion No. 464 (decided June 10, 1965). While Btu adjustments have not played a major role in the Permian Basin in the past we believe it important that our price for new gas-well gas reflect the energy content of the gas, which in reality is what the consumer is purchasing. We therefore believe it is necessary and appropriate to provide an upward adjustment for this premium quality feature of benefit to the consumers as well as to provide downward adjustments for deficiencies in quality for new gas-well gas. Such adjustments are to be used in computing the applicable price for new gas-well gas irrespective of whether the underlying contracts contain a Btu adjustment clause. However a producer will of course be limited by his contract if it is below the applicable ceiling as adjusted.

We believe the weighted average Btu content of gas-well gas in the area should generally be used as the guideline for upward adjustments. The weighted average Btu content for gas-well gas in the Permian Basin as shown in Exhibit 118 is 1,042 Btu's per cubic foot. That exhibit reflects the facts for over half of the gas-well gas in the area, and while the precise figure may be somewhat higher

or lower, the exhibit indicates that the weighted average is certainly well above 1,000 Btu's per cubic foot and does not exceed 1,050 Btu's. Accordingly, in computing the quality adjustments to the ceiling prices for new gas-well gas we shall permit an upward Btu price adjustment from a base of 1,050 Btu's per cubic foot on a proportional basis above the ceiling price fixed herein. The record also reveals that a minimum standard for pipeline quality gas in the Permian Basin is 1,000 Btu's per cubic foot. The 1,000 Btu minimum is not a national standard but is based on the evidence of the practice in the Permian Basin. We shall accordingly provide a downward adjustment for new gas-well gas from a base of 1,000 Btu's on a proportional basis from the ceiling price fixed herein.[46] The range of 1,000 to 1,050 Btu in which no adjustment will be required in the Permian Basin is not necessarily controlling for other areas where the record may well suggest a narrower range.

The Btu content of the gas to be used in determining price adjustments can be defined as the total heat value of the standard cubic foot as specified in Opinion No. 464. So that no producer will be penalized twice by the application of a reduction in rate for Btu deficiency in addition to a reduction required by the presence of carbon dioxide or other impurities, the Btu content should be measured after any necessary processing of the gas to remove impurities, as well as after removal of any liquids

[46] For example, new gas-well gas containing 1,155 Btu's will be allowed a 10 percent increase in rate, and new gas-well gas containing 950 Btu's will be subjected to a 5 percent reduction in rate.

for which the buyer pays separately, whether on a percentage basis or otherwise.

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Pressure

The question of pressure is more complex. Gas cannot enter a pipeline unless it is under greater pressure than the pipeline pressure at the point of entry. Gas of lower pressure must be compressed to raise its pressure above that of the pipeline which it is entering. It is not the number of pounds by which a given quantity of gas may fall over pipeline pressure that is important, but the number of stages of compression through which the gas must be put in order to raise its pressure sufficiently. The majority of the main-line pipelines in the continental United States operate to maintain a pressure at the compression stations ranging from 800 pounds to 1,000 pounds per square inch (psi) or about 900 psi on the average. Evidence in this case of actual delivery pressures for producers in the Permian Basin indicates that pipeline purchasers in the Permian area have main-line operating pressures averaging about 800 psi. Thus we are presented with the question of whether a national pressure standard of some 900 psi should be adopted here or whether we should use the average pressure in the Permian Basin of about 800 psi.

It could be argued that where national average cost is used in establishing a ceiling price, the average national pressure should also be used in establishing the standards

to which gas priced at the ceiling must conform. However, the prices we fix here are area prices, and may be modified in other areas for factors other than cost. The adoption of a 900 pound pressure standard for the Permian Basin would require a price reduction on all Permian Basin residue gas and nearly all gas-well gas. While delivery of gas at higher pressure would confer some benefits on the pipeline (by reducing the amount of compression needed to move gas along the pipeline) it seems inequitable to penalize the producers and processors who deliver gas at the pressure for which the pipeline is designed and who in many cases could have delivered it at higher pressure if called upon to do so, without additional expense. The physical equipment in the Permian Basin is now largely geared to delivery at 800 pounds pressure. We shall therefore adopt an 800 pound pressure standard for the Permian Basin.

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The Amount of Price Adjustment

In accordance with the foregoing, we set forth the following principles to govern price adjustments when a purchaser buys gas which deviates from the standards here established for gas of pipeline quality:

(1) The applicable ceiling price shall be adjusted downward by the net cost of processing the gas to bring it up to standard, by the amount of any applicable upward or downward Btu adjustment (for new gas-well gas only) and by the amount of any sav-

ing or additional expense to the seller from any reduction or increase in taxes or royalty payments resulting therefrom.

(2) If the processing is performed by the purchaser, a reasonable return upon the required investment should be included as a part of the processing cost incurred in bringing the gas up to pipeline quality.

(3) If processing reduces the volume of the gas, the purchaser shall pay for only the volume remaining after processing.

Procedure

In establishing a procedure for determining the amount of the reduction in the ceiling price applicable in the case of gas with quality deficiencies, our purpose is to impose the minimum regulatory controls required to carry out effectively our responsibilities to assure wholesale customers that the price they pay will be just and reasonable. Accordingly, sales by small producers that are covered by the proposed small producer certificate rule, shall be exempt from such adjustments on the *de minimis* principle, because the burden and expense involved would in most cases exceed the amount of the adjustments. Furthermore, the major producers, processors, and pipelines will be allowed in the first instance to establish among themselves, in accordance with the standards set forth here, the amounts by which ceiling prices should be adjusted in the case of each individual contract which deals with gas which deviates from the quality standards

herein established. If the parties reach agreement that no change from the ceiling price is required or that a specific price adjustment is required, a statement

of the agreed price for the gas shall be filed no later than 90 days from the effective date of this order. The producer as part of the statement shall itemize the amounts and nature of each of the quality adjustments and explain the basis therefor, and set forth the price agreed upon by the parties as representing the applicable ceiling price as adjusted.

If the parties are unable to agree upon any or all of the quality variations of the gas or the costs of remedying defects (except for sales by small producers exempt from these quality adjustments), the required statement must so indicate and the seller must supply the itemized information required to compute the applicable ceiling price as adjusted. The buyer will be given an opportunity to state its position and the Commission will then determine the applicable area rate. Pending such determination, the seller may collect a price not in excess of the unadjusted area ceiling price for the type of gas in question, subject to the obligation to make refund of any excess collected, from the effective date of this order, above the applicable area rate (the ceiling rate reduced by the cost of processing to correct quality deficiencies and, in the case of new gas-well gas, further adjusted for Btu variations) ultimately determined to be proper.

No pipeline will be entitled, as part of its cost of service, to any amounts paid for gas in excess of the applicable ceiling price as adjusted in accordance with the standards and principles set forth in this opinion. The acceptance for filing of any amendment or certificate, or the failure to suspend any rate so established, shall not prevent the application of this rule.

It is our expectation that this procedure will result in the parties determining the proper adjustments in price levels to reflect differences in the quality of gas sold. Should this objective not be realized and should the Commission be confronted with a large number of contests, or should it be found that evasion or abuse is prevalent, it may be necessary to take measures to fix the precise price variations corresponding to variations in gas quality.

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PETITIONS FOR SPECIAL EXEMPTION FROM THE AREA RATES

We have already discussed *supra* at pages 11-19 why we believe that maximum area rates can and should be established as the just and reasonable rates applicable generally to the sales of natural gas in the Permian Basin. The question remains what procedure or procedures should be adopted for the benefit of those respondents who, by reason of special circumstances, believe they can demonstrate that they are entitled to variant treatment.

First, we should frame the limits of the problem. We are not here treating sales to be permanently certificated after the effective date of this decision. In the future it would normally not be in the public interest to certificate sales of gas (including gas flowing under temporary certificates) at initial prices above the applicable area rate. While we do not visualize any reason for certifying any new sales at prices above the just and reasonable ceiling price, any producer unwilling to accept a certificate at the appropriate ceiling will have an opportunity to show in the hearing on his certificate application the special circumstances which he believes warrant making an exception in his case in the public interest.

The problem for our immediate attention thus relates solely to gas presently being sold under outstanding certificates. Our decision herein has a double impact on the gas presently flowing in interstate commerce from producers in the Permian Basin. It fixes a price for the future, and it determines the basis for refunds for past periods. We shall first discuss the basis for permitting special exceptions to the area rate with respect to future rates for flowing gas and later discuss the question of relief from refund requirements.

It would seem clear that where a producer who has contracted for an above-ceiling price can show that his out-of-pocket expenses in connection with the operation of a particular well are greater than the revenues under

the applicable area price, he should be entitled to appropriate relief, and there may be other circumstances where a producer as a matter of law or in the public interest would be entitled to some relief.

We need not and cannot here specify all of the special circumstances which may serve as a basis for exceptions to the area rate. It is clear however that confiscation does not result merely because, as a result of high costs or low production, a given producer cannot, at the area price, recover his expenses for his unsuccessful exploration and development costs and earn the 12 percent overall return on producer investment rate base which we have adopted as the appropriate return to attract capital on an area-wide basis for gas exploration and development. We recognize that any amounts received by the producer for flowing gas above out-of-pocket expenses would be available to finance further exploration, but no producer has a constitutional right to a price for the future which will enable him to expand his venture in the interstate gas business and the inability to earn such allowances at the area ceiling cannot be characterized as confiscation. As the Court of Appeals for the District of Columbia recently observed, "the Commission is not required to subsidize high cost producers with consumers' money." *Atlantic Refining Co.* v. *F.P.C.*, 316 F.2d 677, 680 (CADC, 1963); see also *Callery Properties, Inc. et al.* v. *F.P.C.* 335 F.2d 1004 (CA5, 1964). The same rule certainly applies to the development of reserves which are held off the market for speculative purposes.

Even in situations where producers are able to show that they are entitled to relief from the obligation to con-

tinue to sell flowing gas at the appropriate area ceiling, in most cases it may be sufficient to permit them to abandon their unprofitable sales. Unlike the case of some public utilities which cannot abandon service without harming the public dependent thereon, we will seldom have a situation in which a particular producer's

abandonment of some or all of its sales in the area will significantly affect the purchasing pipeline, to say nothing of the ultimate gas consumer. There may, however, be some exceptional situations where abandonment could be shown to be detrimental to consumers, or where the producer could demonstrate that some other form of relief would best serve the interests of the public as well as his own.

The remaining confiscation question is with respect to refunds for past periods. On a composite basis the area ceiling prices for both flowing and new gas provide a reasonable allowance for exploration and development and production operating expenses in addition to a 12 percent return on the producing investment. As we stated earlier, a claim that it would be confiscatory to require the refund of amounts a producer has collected above the area rate cannot be supported by the fact that a particular producer in the past has chosen to spend more than a reasonable allowance in what proves to be unsuccessful or marginal exploratory efforts or by the fact that unit production costs are high because for speculative purposes

or other reasons the producer has withheld from production gas that he has discovered. On the other hand it seems clear that a producer should not be required to make refunds for past periods which would deprive him of amounts sufficient to cover his out-of-pocket operating expenses in the Permian Basin for such period. We need not consider other situations at this stage of the proceeding; it is sufficient to note that here too we will entertain petitions for special relief, and that the dockets involved will remain subject to the existing interest obligations pending their resolution.

We need not speculate further here as to the exact circumstances in which special relief may be warranted from the area price maximums for some or all of a producer's sales, or the appropriate nature of such relief. Any producer claiming that he is entitled to special relief from the maximum rate set for any of his Permian sales or from the refund obligations imposed herein may file a petition for such relief with the Commission consistent with the general guidelines set forth herein. Any such petition will be disposed of as promptly as possible.

Since the petitioner will bear the burden of showing that he is entitled to special relief the producer (unless authorization is granted for temporary abandonment) will not be relieved of his obligation to continue service at the appropriate just and reasonable rate pending the determination

of his petition. See *The New England Divisions* case, 261 U.S. 184, 198-199 (1923).

CHANGES IN THE AREA RATE

Our adoption here of a two-price vintaging system of fixing just and reasonable producer prices simplifies questions as to the appropriate or permissible methods for changing such prices. The two-price system enables us to provide a higher price for future discoveries if justified by changed circumstances. It is unlike the situation resulting from the utilization of a single price based upon historical costs, where significant changes in conditions may necessitate a change in the just and reasonable price for all gas. For example, an indication that new well drilling costs were increasing might (all other things being equal) demonstrate that a higher price should be set for gas certificated at some date in the future but would not necessarily show that the just and reasonable price we here prescribe for gas already flowing requires revision. Other changes unrelated to the continuing operations under which flowing gas is brought to market will be relevant only to the question of whether a new price should be set to govern future sales, thus permitting price stability for gas already dedicated to the interstate market.

This does not mean that the just and reasonable price for flowing gas can never vary. We have fixed the price of the pre-1961 gas-well gas and all other gas on the basis of the composite cost showing of gas-well gas for the Permian Basin in 1960. Of course if it could be shown that the average rates of take of such gas had

significantly dropped or that the continuing operating costs of the gas wells had increased significantly, it might well be that the maximum just and reasonable price for such gas should

be adjusted. This would also be true for the gas coming into the market since 1960, although the evidence of record indicates that costs have remained remarkably steady during the ensuing years and are likely to remain stable during the moratorium period prescribed herein. Essentially, under the type of pricing we are instituting, the cost of flowing gas-well gas and all casinghead gas and residue gas derived therefrom will tend to remain relatively constant and permit stable rates, even though changing circumstances might demonstrate the need for new and substantially different rates for gas-well gas coming on to the market at later periods.

In this framework, we approach the question of the appropriate mechanism for altering the area rates. We can, of course, in this proceeding fix the just and reasonable price only for gas flowing pursuant to outstanding certificates. We believe that a moratorium for new rate increase filings above the applicable area ceiling prices for a 2½ year period is essential if our decision herein is to achieve effective control over producer prices. In the absence of such a moratorium the producers would be free to file rate increases and continue to collect their producer prices even though they exceeded the just and

reasonable rates herein prescribed. Without a moratorium, the conclusion of one area proceeding would only signal the beginning of the next, and just and reasonable rates for consumers would always be one area proceeding away.

The Supreme Court recently noted the obvious inadequacies of the refund obligation as a protection of the public interest (*F.P.C.* v. *Tennessee Gas Transmission Co.*, 371 U.S. 145, 154, 155 (1962); *F.P.C.* v. *Hunt*, 376 U.S. 515, 524 (1964)). Without the moratorium we have provided the public interest could be protected only to the extent that the Commission could devise procedures to enable it to complete an area proceeding within the 5-month suspension period or shortly thereafter. See *F.P.C.* v. *Tennessee Gas Transmission Co.*, *supra;* cf. *Panhandle Eastern Pipe Line Co.* v. *F.P.C.*, 236 F. 2d 606 (CA3 1956).

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While the Supreme Court's description of a Section 5 producer rate proceeding in the *Catco* case as "well nigh interminable" is, we hope, no longer apt, the more than four-year history of this case, conducted with acute awareness of the running of time, demonstrates that we are dealing with inherently time-consuming proceedings. We expect to complete future area cases in much less time, but we would be unrealistic in the extreme to assume that any rate proceeding could be completed in less than several times the length of the 5-month suspension period. Without the limited moratorium on rate

filings prescribed by our order herein this mammoth proceeding would fix prices for only a 5-month period and the producers could then overturn the Commission's order by a series of new filings to reinstate their pre-existing rates.

It is our view that the filing of rate increases by a natural gas company pursuant to Sections (d) and (e) can be limited either by private contract or as a result of the reasonable exercise of this Commission's authority under Sections 5, 7 and 16 of the Act. Certainly, it would be an anomalous situation if the filing of rate increases could be restricted by private bargaining but not by reasonable exercise of regulatory authority in the public interest. We have exercised such authority in this initial proceeding fixing rates on a group basis under the Natural Gas Act because it is an essential feature of the area approach if it is to achieve effective control over producer prices for the protection of consumers. We believe the 2½ year period is the minimum time required to afford price stability that will be beneficial to consumers and the industry as well. Considering the evidence of stable costs, and the provisions for earlier relief, if warranted, this limited moratorium is not unfair to producers.

The producers nevertheless contend that pursuant to the provisions of Section 4(d) of the Act, a natural gas company has a right to file any contractually authorized rate increase even if the Commission has just held that the maximum just and reasonable price for such sale is of a lesser amount. They argue that the only procedure available

to the Commission is to enter into the suspension and hearing procedure established by Section 4(d), with the company having the right to put the increase into effect subject to refund at the end of the maximum statutory five months' suspension period.

We do not believe that the Commission's powers are so limited that its regulatory efforts must be futile where after a long and full hearing we have determined the just and reasonable rates to be set for the future. The *Mobile* case (*United Gas Pipe Line Co.* v. *Mobile Gas Service Corp.*, 350 U.S. 332, 339 (1956)) made clear that:

> * * * § 4(d) is simply a prohibition, not a grant of power. It does not purport to say what is effective to change a contract, any more than § 4(c) purports to define what constitutes a "contract" that may be filed with the Commission. The section says only that a change *cannot* be made without the proper notice to the Commission; it does not say under what circumstances a change *can* be made * * * [emphasis in original]

It is true that despite the Court's explanation of the meaning of Section 4(d) as simply a prohibition on filings, and not a grant of power, the opinions of the Court in *Mobile* and in the subsequent *Memphis* case (*United Gas Pipe Line Co.* v. *Memphis Light, Gas & Water Division*, 358 U.S. 103 (1958)), contain dicta to the effect that a pipeline can file for such increases as

are contractually authorized and after the suspension period, put them into effect subject to refund. See also *Atlantic Refining Co.* v. *Public Service Commission of New York* (CATCO), 360 U.S. 378 (1959). These dicta must be read in context of the issue raised in the cases, which was the effect of restrictions on increased rate filings by pipelines stemming from contractual limitations by the parties in circumstances where the pre-existing rate had not been fixed by the Commission pursuant to its authority to prescribe just and reasonable rates for the future. These cases dealt with regulation on an individual company basis in which there is a long administrative

history of permitting increased rate filings and where the Commission as a matter of policy has never written a moratorium into a rate order. They are entirely consistent with our recent order in *United Gas Pipeline Co.*, RP65-1, ... F.P.C. ....., issued October 22, 1964, where in refusing to reject an increased rate filed by a pipeline we made clear that "the Commission is [not] completely without discretion to impose by rule or by order a reasonable moratorium on the filing of rate increases under Section 4(d) of the Act in circumstances where the orderly administration of the Natural Gas Act makes such conditions necessary."

The authority we assert herein is neither novel nor unique as applied to group rates set after full agency hearing. The ICC operating under a statute containing

language virtually identical to Section 4 of the Natural Gas Act long ago stated that "to say that the Commission's order may be defeated merely by publication and filing of a rate higher than that prescribed by the order is to say also that the shipping public is not entitled to the protection of this Commission's orders during the period they are in force * * * *." (*City of Springfield, Tenn.* v. *Louisville N.R. Co.*, 53 ICC 603, 605, 606 (1919); see *Fifteen Per Cent Case*, 45 ICC 303 (1917).) The CAB has similarly held that a group rate fixed by the Board could only be modified by subsequent Board action and not by a carrier's unilateral filing. *Minimum Rates Applicable to Air Freight* Order No. E-17370, 34 CAB 263 (1961).

The Supreme Court has expressly held in *United States* v. *Corrick*, 298 U.S. 435, 439, 440 (1936), that where the Secretary of Agriculture under the provisions of Section 310 of the Packers & Stockyards Act (7 U.S.C. § 211 (1921)) prescribes "the just and reasonable rate or charge, * * * to be thereafter observed" such rates "become the only lawful rates and so remain until further order of the Secretary" and cannot be altered by the unilateral action of a particular marketing agency pursuant to provisions of Section 306 of the Packers & Stockyards Act (7 U.S.C. § 207). That section is virtually identical with Section 4 of the Natural Gas Act.

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It cannot be argued that the ICC and Packers & Stockyards Acts precedents are not in point because those acts

expressly provide that orders fixing just and reasonable rates "shall continue in force until [the agency's] further order" (see Interstate Commerce Act, § 15(2), 49 U.S.C. § 15(2); (1887); Packers & Stockyards Act, § 313, 7 U.S.C. § 214). The ICC adopted the position noted above before the language in question was introduced into its Act in 1920[47] and the Supreme Court in *Corrick* supported its conclusion not by reference to the different language of Section 313, but by the quoted language of Section 310 which parallels Section 5(a) of the Natural Gas Act and by citing its earlier decision in *Arizona Grocery Co.* v. *Atchison T.&S.F. Ry. Co.*, 284 U.S. 370 (1932), standing for the general proposition that where the agency "declares a specific rate to be the reasonable and lawful rate for the future, it speaks as the legislature and its pronouncement has the force of a statute" (284 U.S. at p. 386).

The absence in the Natural Gas Act of language similar to that found in Section 15(2) of the Interstate Commerce Act and Section 313 of the Packers & Stockyard Act, means only that Commission orders under Section 5(a) do not automatically have the effect of tolling the availability of Section 4 filings (see *United Gas Pipe Line Co., supra*). It leaves the Commission free to exercise its express authority to "fix" by order "the just and reasonable . . . rule, regulation, practice or contract to be thereafter observed and in force" (Section 5(a)) and to "perform any and all acts and to prescribe . . . such

[47] Cf. Section 3 of the Hepburn Act of 1906 (34 Stat. 589) with Section 418 of the Transportation Act of 1920 (41 Stat. 484).

orders, rules and regulations as it may find necessary or appropriate to carry out the provisions of this act" (Section 16); See *Public Service Commission of New York* v. *F.P.C.*, 327 F. 2d 893, 896-897, (CADC, 1964).

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The Commission under Sections 5(a) and 16 of the Natural Gas Act may impose a reasonable moratorium on increased rate filings under Section 4 which are inconsistent with the just and reasonable rates found after hearing, and require that during this period the just and reasonable rates be changed, if at all, solely by modification of its original decision after appropriate proceedings held in that docket. The orderly administration of the Natural Gas Act necessitates that we exercise such authority in fixing the rates for sales by gas producers on an area basis.

It will therefore be our policy to certificate new sales of gas in the future at initial prices no higher than the just and reasonable price for new gas, and upon condition that no increased rate higher than the ceiling price be filed before January 1, 1968 (a 2½-year period which we believe to be the reasonable duration for a moratorium on filings for rates higher than the ceiling prices fixed on the basis of this record), unless within such time, either upon the Commission's own motion or upon an adequately supported petition by some interested party, the Commission at its discretion decides to reopen this proceeding to consider whether a different rate or

rates should be adopted for sales certificated at subsequent periods. We expect that the just and reasonable rate for new gas would constitute the maximum price at which new gas would be initially certified, the so-called "in-line" price, until the just and reasonable rate is changed by the Commission.

As to existing sales, whether they fall within the categories to which the flowing gas or new gas-well gas rates are applicable, we shall, pursuant to our authority under Sections 5 and 16 of the Act, similarly provide against any filing of rate increases above the applicable ceiling price fixed herein before January 1, 1968, but will permit any interested party within such period to file a petition directed to the Commission's discretion, showing why it believes the proceedings should be reopened to consider earlier changes. The Commission reserves the right to reopen the proceeding in its discretion to permit earlier changes in rates in the event of drastically changed circumstances. In any event after the 2½-year period, we shall also permit contractually authorized rate increase filings to be made pursuant to Section 4 for all sales in the area.

MINIMUM RATES

The examiner found that certain contracts in the Permian Basin were "below the revenue standards" he adopted. While the record is not clear on this point many of these contracts presumably were negotiated at a time

when natural gas was a by-product of the search for oil and the interstate markets had not yet developed.

To aid in rectifying the situations where producers had contractually precluded themselves from obtaining an increase in price of their gas, the examiner authorized the seller, with the consent of his buyer, to increase his rates up to the minimum established in the decision; to wit, 9 cents per Mcf of gas-well gas and 7 cents per Mcf for casinghead gas.

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The Supreme Court in *F.P.C.* v. *Sierra Pacific Power Co.*, 350 U.S. 348 (1956),[48] recognized that this Commission possesses the power to authorize rate increases despite contractual limitations to the contrary. However, the Court was careful to point out that such an order required as a foundation more than the mere fact that, because of an improvident bargain, a utility was receiving less than a fair price for its product. The Court said (at p. 355): "In such circumstances the sole concern of the Commission would seem to be whether the rate is so low as to adversely affect the public interest — as where it might impair the financial ability of the public utility to continue its service, cast upon other consumers an excessive burden, or be unduly discriminatory."

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[48] Though this case involved the Federal Power Act, the Court noted that: "The pertinent provisions of the Federal Power Act, * * * are §§ 205(c), (d), and (e), and 206(a), which are substantially identical to §§ 4(c), (d), and (e), and 5(a), respectively, of the Natural Gas Act." (at pp. 350-351).

It is thus clear that the test of whether rates should be increased is not one of private equities but of the public interest. It is also clear that the examples set forth by the Court are not, and were not intended to be, the only instances where public interest would justify an authorization to increase rates in contravention of a contract. In addition it should be noted that the *Sierra* case was decided in the context of an individual company rather than an area rate approach.

We concur with the examiner in his conclusion that the establishment of minimum rates in this case is in the public interest and that the price impact on the consumer will be *de minimis*. While on the other hand, the establishment of a maximum price for the area is essential so that the ultimate consumer does not pay a price which is excessive in relation to group costs and other relevant considerations, we believe that a minimum price also

constitutes an integral part of the area rate approach. The rate received by a producer must not be so low as to prevent or retard further exploration and thereby decrease possible discovery of gas reserves which will be needed by consumers. The amount of additional revenue so provided, at the most $250,000 annually, will have no significant impact on consumers but the relief afforded the individual producers involved may be important to their continuation in the search for additional gas sup-

plies needed to meet the growing needs of the consuming markets.

Although we have agreed with the examiner's conclusion as to the need for a minimum rate, we believe that his remedy, which would not allow the producer with sub-minimum rates to raise them to the minimum unless he secured the approval of his purchaser, is not sufficient. Renegotiation of contracts resulting in increased rates which do not exceed the area rate would be proper without any action by this Commission, so that the examiner's remedy would avail nothing.

We therefore deem it necessary and appropriate to establish a minimum rate in this area of 9 cents per Mcf for gas of standard pipeline quality, with adjustments from the minimum price to reflect any deviations from the quality standards established herein, and to hold that the minimum rate herein established may be filed without purchaser approval at any time after this order becomes final.

REFUNDS

We shall require appropriate refunds in the case of rates which are the subject of proceedings under Section 4(e) of the Act, and have thus been collected subject to an obligation to refund amounts collected in excess of the just and reasonable rates as here determined. In each case the proper rate level for computing refunds shall be the area rate applicable to the particular category of gas involved, as adjusted by reason of any quality deviations in the particular gas.

The presiding examiner proposed that the total refunds to be made with respect to contracts for the sale of gas-well gas should be computed for each separate year on the basis of whether the industry as a whole had collected an excessive amount for gas-well gas in that year. Under this proposal, if one producer collected revenues from the sale of gas-well gas in excess of his proper prices, he would be required to refund such excess amounts only if it were shown that the industry as a whole in that year had received revenues from gas-well gas in the area in excess of the proper revenues for such gas. The same principle would be applied with respect to residue gas and to casinghead gas. Further, any deficiency in any year in overall industry revenues from any one of the three categories — gas-well gas, residue gas, or casinghead gas — would be used to offset excessive revenues collected for any other category of gas.

The underlying theory of the presiding examiner's approach is that refunds should be ordered only to the extent that overall industry revenues exceed overall industry expenditures in a given year. The briefs on exceptions indicate that many of the parties are not clear as to how this theory might be applied in particular cases.

Several fundamental objections preclude adoption of the examiner's proposed method of computing refunds. We think it would result in inequities among wholesale customers as well as among individual producers. If one

wholesale customer has been overcharged it is of little comfort to him to know that another customer has received a bargain. Conversely, if one producer has collected excessive amounts, he should not be relieved of his responsibility to return the excess by reason of the fact that some other producer collected too little. Furthermore, the administrative difficulties involved in attempting for each year, and each category of sales, to equate industry revenues with industry expenditures, and to allocate the excess revenues among the purchasers, seem almost insurmountable.

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We have established just and reasonable ceiling prices for the Permian area, with adjustments from the ceiling prices in the case of gas which deviates from the quality standards we have established. The applicable ceiling price, including any quality adjustments, is the proper price for gas sold under a particular contract. We think it is proper and equitable to require refunds of amounts collected in excess of the ceiling price for gas sold under each contract. This has been our practice in prior proceedings under the Natural Gas Act, and on this record we see no reason, legal or equitable, to fail to return to the wholesale customers the excess sums they have paid. To the extent that any producer receives a lesser amount than our ceilings permit it is because he has agreed to prices which yield that amount or failed to file for a higher rate.

Refunds will be required only with respect to the rates which are the subject of Section 4(e) proceedings, and only for the periods during which such rates have been collected subject to refund.

A refund procedure must be established. We have determined that price adjustments corresponding to departures from standards shall be left to the parties for initial determination, if they are able to agree. The price applicable to particular gas cannot be finally determined until the parties have determined the quality of gas and the computed corresponding price adjustments. Accordingly, each producer (except small producers, who will be considered below) shall file a computation of refunds due with respect to each rate schedule within 30 days from the date of the filing of an agreement with his purchaser as to the quality of the gas sold and the cost per Mcf of processing such gas to pipeline quality standards. If no such agreement is reached the refund computation is to be filed within 30 days from the date of Commission determination of the quality adjustments. (See pp. 102-103 hereof for procedure).

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In the case of Section 4(e) proceedings, the refund computation shall also be made for all periods during which rates were collected subject to refund. With regard to each rate schedule, such computation shall specify the applicable rate or rates as established in accordance with the principles set forth in this opinion (including

any adjustments for quality as prescribed herein), the rate or rates collected during the period subject to refund, the period during which any rate was collected in excess of the proper applicable rate, the volume of gas for which such excess rate was collected, and the amount of refunds due. Interest on such refunds (at the prevailing rate) shall be included in the computation.

Each producer will be directed to retain the refunds to be made by him until further order of the Commission. Such retention shall be in accordance with the option principle established by the Commission in *Humble Oil and Refining Company*, 32 FPC 49, Docket Nos. G-9287, *et al.*, issued July 8, 1964.

The rates for small producer sales as defined in the rule providing for small producer certificates for such sales proposed this date are not required to reflect any quality adjustments either for past periods or for the future. Small producer refund obligations will therefore extend only to refunding amounts

collected subject to refund in excess of the amounts collectible under the base ceiling rates. If a small producer wishes to take advantage of any permitted upward adjustment for new gas-well gas of high Btu content, he will be required to indicate also any offsetting deficiencies in quality of the gas in question by filing the same statements required of large producers.

SMALL PRODUCER PROBLEM

There have been many suggestions, foremost of which are those by Justice Clark dissenting in *Wisconsin* v. *F.P.C.*, 373 U.S. 294, 329-30 (1963), and speaking for the Court in *F.P.C.* v. *Hunt*, 376 U.S. 515 (1964), to the effect that this Commission should consider procedures for the exemption of small producers from regulation. There are many compelling arguments to justify distinctive treatment of small producers. The justification goes beyond the obvious benefits of relieving the small producer of the expense and burden of the regulatory process. Among other considerations, expediting the administrative process and facilitating effective regulation are suggested as additional benefits.

The examiner has set forth a well documented argument for recognizing the special problems of the small producer and affording him separate regulatory treatment. At the very heart of his analysis are two basic propositions which serve to distinguish the small producer from the large. The first is simply a recognition of the characteristic of "smallness," which as the examiner has said means that the typical small producer has limited operations and is thus subject to a greater degree of risk than is a large producer.

The examiner's second proposition is that the small producers, although numerous, account for a relatively small share of the natural gas produced in this country, and that

even without regulation they usually cannot obtain more for their gas than the regulated price we fix for the major producers. In the nation there are over 2,000 small producers as defined by the examiner, *i.e.*, those selling less than 10 million Mcf of gas per year, filing rate schedules with this Commission. They provide only about 15 percent of the total supply of natural gas moving in interstate commerce. The examiner concludes that the exclusion of the small producer from direct price control would thus have a *de minimis* impact on the consumer while the effect on the small producer would be highly beneficial. His procedural device for according exemption was a blanket finding that all the rates of the small producers were just and reasonable.

We agree with the examiner in general that special treatment of the small producer group offers scope for streamlining the regulatory process without the risk of substantial impact on consumer prices. Consumers and the natural gas industry alike have a strong stake in the continuation of the exploration efforts of the thousands of small operators, who contribute a large share of the discoveries of new sources of gas. Easing the burdens of regulation would help to assure their continued participation in the gas production business.

While we are convinced that there is need for distinctive treatment for small producers, which we shall provide herein, we do not believe it is necessary or desirable

to provide outright exemption. We reach this conclusion assuming that exemption is legally permissible despite the mandatory language of Sections 4 and 7 of the Natural Gas Act.[49]

In our opinion the salutary objectives of those who propose exemption can better be achieved within the framework of regulation. Furthermore, any exemption for small producers would be more an illusion than a reality. As the small producers suggest, the area ceilings we prescribe will tend to set the maximum prices they can obtain for their gas.

A basic consideration in reaching our conclusion in this matter is that the impact of small producer prices on consumers is by no means *de minimis* on an area basis, and is of great impact in some situations. Sales by small producers constitute 80 percent of the gas supply of one pipeline[50] and range from 9 percent to about 60 percent

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[49] Section 4(a) states in part that "*all* rates and charges" by "any natural gas company shall be just and reasonable." In Section 4(c) it is stated that "Under such rules and regulations as the Commission may prescribe, *every* natural gas company shall file * * * in such form as the Commission may designate, * * * *all* rates and charges * * *."

Section 7(c) provides in part that "No natural-gas company * * * shall engage in the transportation or sale of natural gas, subject to the jurisdiction of the Commission * * * unless there is in force with respect to such natural gas company a certificate of public convenience and necessity * * *."

[50] Kansas-Colorado Utilities Company, see F.P.C. Form 2.

of the supply of the other 25 largest pipelines. While small producers represent only 15 percent of the aggregate interstate gas supply it is obvious they are a substantial factor in the cost of the gas supply of millions of American consumers.

Another consideration which weighs with us is that penetration of rate ceilings, even on a small scale, could be seriously disruptive of a pattern of uniform area ceilings.

The examiner suggested relief for small producers from present filing requirements in the following manner: (1) a general certificate would issue to those natural gas companies which meet the qualifications of a "small producer", and (2) such producers would be required to file annual statements containing information as to their jurisdictional sales. The small producers in this proceeding support these suggestions.

We are interested in affording real relief to the small producers and in providing meaningful measures to clear our dockets and facilitate effective regulation. We recognize the burdens to small producers of complying with the filing requirements promulgated pursuant to Section 7 of the Natural Gas Act before new gas supplies can be connected. Such filings, which are routinely handled by the larger companies can, in the case of a small producer, strain his resources. The time lag, even the few weeks required under our expedited procedures, can deprive a

small producer of badly needed income. In light of these circumstances the Commission finds that it is necessary and appropriate to afford the small producers relief as provided below and we are issuing a notice of proposed rulemaking, this date, to implement our conclusions.

A small producer is thereby defined to be a natural gas company selling jurisdictionally less than 10,000,000 Mcf annually on a nationwide basis. Such a classification will include almost 250 of the filing producers in the Permian Basin and leave about 40 major companies subject to the filing requirements of Section 7 for individual sales. Nationally this breaking point would classify approximately 2,000 producers as small and about 75 as major companies. We believe that the record amply supports this reasonable classification made pursuant to Section 16 of the Act. For this purpose, the combined jurisdictional sales of affiliated companies (as further defined in the rule issued this date) will be considered as the sales of a single producer.

Companies or individuals in the Permian Basin qualifying as small producers will be granted small producer certificates pursuant to Section 7 of the Act authorizing all future small producer sales (as defined therein) in the area at or below the applicable area ceiling rate, thereby eliminating the need to obtain separate certificates for each sale as is presently required. This action will not only relieve the producers and the Commission of a large paperwork problem, it will enable small producers to bring their gas to market without any regulatory delay.

Sales in areas other than the Permian Basin by small producers will not be eligible for coverage by such certificates until an area rate is fixed therein because the determination of a specific area rate is a prerequisite for the issuance of such certificates.

All producers in the Permian Basin who apply and qualify as small producers under our proposed rule issued this date will be granted special certificates as to their Permian sales which will cover not only any future small producer sales (as defined therein) made within our area ceiling prices, but also all such sales for which a separate certificate has already been issued. Naturally, these certificates will be subject to the limit of 10,000,000 Mcf of annual jurisdictional sales on a nationwide basis and to area rate limitations. Those certificate applications within the ceiling pending before the Commission by small producers in the Permian Basin that come within the proposed rule will be covered within small producer certificates and any applications for certificates above ceiling will be granted conditionally upon acceptance of an initial price no higher than the ceiling.

Recipients of the small producer certificates will be required only to file annually a simple one-page statement in which they will state the total volume of jurisdictional

sales and certify that all such sales were within the applicable area ceiling. The producers holding such certificates will no longer be compelled to file Forms 301-A or 301-B,[51] nor will they be required to file individual initial rate schedules pursuant to Section 4(c) of the Act for the small producer sales. Furthermore, in light of our decision to accept all rate increases up to the area rate, holders of small producer certificates will not hereafter be required, under Section 4(d) of the Act, to file such changes for their small producer sales as they are made. Section 4(d) requires such filings "Unless the Commission otherwise orders * * *." We believe that inclusion of information pertaining to these changes, in the annual reports of the pipeline purchasers, will satisfy not only the language but also the purpose of Section 4(d). Of course, no increases above the applicable area ceiling will be permitted without the approval of the Commission pursuant to the filing requirements of Section 4(d).

Should a producer cease to be a small producer by virtue of an increase of jurisdictional sales to a level in excess of 10,000,000 Mcf in a year, or should he propose to sell at prices above the area rate, or should he make sales which do not qualify as small producer sales he must abide by the present requirements, *i.e.*, his certificate will not apply to such situations. Specific details of the small producer relief are explained in the Notice of Proposed Rulemaking issued this date.

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[51] Presently required by the Regulations under the Natural Gas Act, Sections 260.5 and 260.6.

MISCELLANEOUS ISSUES

Favored-Nation and Spiral Escalation Clauses

The Presiding Examiner stated:

> . . . Most favored nations clauses and spiral escalation clauses cause price increases in a contract price to occur without reference to the circumstances or economics of the particular operation, but solely because of what happens under another contract. These clauses contravene the public interest and the basis on which prices have been determined in this decision. They are therefore declared to be inoperative and of no legal effect. No change in a rate resulting from such indeterminate pricing provisions will be permitted to take effect under this decision and order. (Initial Decision, p. 74)

The examiner correctly observed that most favored-nation clauses and spiral escalation clauses are not in accordance with the principles upon which a rate structure should be based. We have proscribed the filing of contracts containing such clauses executed on or after April 2, 1962. (Order No. 242, 27 FPC 339; *F.P.C.* v. *Texaco*, 377 U.S. 33.) We do not think, however, that such clauses in contracts already accepted for filing at the time of our order outlawing such clauses for the future should be denied effect insofar as they serve to permit filings up to the applicable area prices prescribed herein. When the contracts containing such clauses were negotiated such

clauses were a part of the bargain arrived at between the parties. Had they been proscribed at that time, escalation clauses of permissible types might well have been substituted. In any event there is no reason in the public interest to prevent rate adjustments which will permit producers to collect a just and reasonable price for their gas. These indefinite escalation clauses will, of course, like all other escalation clauses, be subject to the moratorium provisions discussed *supra* at pages 107-114 and, as the examiner ruled, such clauses will not be permitted to authorize rate filings above the applicable area rates subsequent to the expiration of the moratorium period.

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Application of the Order

This proceeding, instituted under Section 5(a) of the Natural Gas Act, will determine the just and reasonable rates to be hereafter observed and in force for all jurisdictional sales being made under respondents' rate schedules. Such rates will apply as ceilings to all sales of respondents whether they were being made at the time we instituted this proceeding or were begun subsequent thereto. Certain of the respondents argue that our order cannot apply to rates established in contracts filed by such respondents after this proceeding was instituted. The argument has no merit. The evidence in this proceeding is based on a composite showing of the overall production in the area and fixes an area rate specifically designed to be just and reasonable for all jurisdictional sales in the area.

To hold otherwise would require an unending succession of Section 5 area rate proceedings, each covering only the sales instituted prior to the institution of the proceeding. We are not required to engage in any such massive duplication of effort. This proceeding was instituted to determine the just and reasonable rate or rates for the sales of natural gas produced in the Permian Basin subject to the jurisdiction of the Commission (Ordering Paragraph "A" of Order Instituting Hearing, 24 FPC 1121 (1960)). Consistent with the provisions of Section 5(a) of the Act, our Order will apply to all of respondents' sales in the described area. (See *United Gas Co.* v. *Mobile Gas Service Corp.*, 350 U.S. 332, 341 (1956)).

A few certificates have been issued since the institution of this proceeding authorizing sales in the Permian area by persons not respondents in this proceeding. Our Order here will not apply to these sales, but the parties making such sales will by separate order be directed to show cause why the area rates should not be applied to them.

Finally, with respect to certain of respondents' sales, increased rates have been filed subsequent to the institution of this proceeding and the dockets involving such increased rates (collected subject to refund) have not been consolidated herein. The above-stated reasons why our determination should apply to newly certificated sales is equally applicable to these nonconsolidated increased rate filings and the record in this proceeding would appear to

be adequate to determine the rates to be hereafter collected for these sales and to determine refund obligations. However, the dockets involving the increased rates were not consolidated herein and the respondents have not been afforded a hearing respecting their refund obligations. Accordingly, we shall not order refunds in these dockets but instead institute a separate proceeding requiring respondents to show cause why the rates here determined should not be utilized in determining their refund obligations.

Examiner's Witness Frazier

Continental (Brief on Exceptions, p. 78) on behalf of the Major Producer Group contends that the presiding examiner improperly called as his own witness Charles H. Frazier, then Director of Development for the Philadelphia Gas Works Division of The United Gas Improvement Company, and that he used Mr. Frazier's testimony as the basis for the dual pricing system, his pricing and location differentials, and rate design. The Major Producer Group argues that the burden of proof is the Commission's and that in the Section 5 part of the proceeding, it is well-settled that the commingling of the investigatory and adjudicatory phases of an administrative proceeding violates due process of law and the specific requirements of the Administrative Procedure Act. They note that Section 1.30(f) of our Rules, like Section 5 of the Administrative Procedure Act, provides that one engaged in the investigatory phase must not participate in the decisional process.

It should first be observed that neither Section 5(c) of the Administrative Procedure Act nor Section 1.30(f)

of our Rules by its terms applies in rate proceedings. Thus, even if it were assumed that the examiner in calling his own witness was acting in an "investigative" role, he

did not violate either the Act or the Rules. More important, however, the examiner's action was not "investigative" but a proper function of the trial examiner in a hearing. Both the Senate and House Committee Reports on the Administrative Procedure Act expressly point out that hearing officers "have the authority and duty — as a court does — to make sure that all necessary evidence is adduced."[52] The Act confers authority for what the examiner has done (see Section 7, *passim*). We also note that the state courts have approved the action of a judge in calling his own witness. *Ramsey* v. *Mading,* 217 Fac. 2d 1041 (Wash. S. Ct.); *Hunt* v. *State,* 248 Ala. 217, 27 So. 2d 186, 193; and *People* v. *Rotello,* 329 Ill. 448, 171 N.W. 540, 542. See also 9 Wigmore, Evidence 267-270; 3 Wigmore, Evidence 151-153; 4 Jones, Evidence 1685.

It is suggested that Witness Frazier may have had an interest in the proceeding because his employer, a gas distributor, though not a party in this proceeding, is an intervener in other area proceedings. This point, however, only goes to the weight to be given his testimony,

[52] Sen. Doc. No. 248, 79th Cong., 2d Sess., page 207. See also House report at page 268.

not its admissibility. If interest in the proceeding were a disqualification most of the evidence in this case would be stricken. See 4 Jones, Evidence, 1865-1966.

Witness Frazier's background and employment status were well known at the time he was called and are a matter of record. Respondents were given a full opportunity to cross-examine Frazier and to bring out anything which would impeach him either by way of challenge to his qualifications as an expert witness or challenge to his views because of his interest. His testimony, of course, is entitled to no more credence because he was called by the examiner rather than by a party. We conclude that the calling of Witness Frazier was proper and has not been shown to have resulted in any prejudice to respondents.

The Commission further finds:

(1) Each of the respondents listed in Parts I and III of Appendix A to this opinion is, and at the time of all past sales with which we are here concerned was, a natural gas company within the meaning of the Natural Gas Act and is engaged in the sale of natural gas in interstate commerce for resale for ultimate public consumption, subject to the jurisdiction of this Commission.

(2) Past, present, and proposed sales of natural gas to which the order herein applies are subject to the jurisdiction of this Commission.

(3) Rates for all sales of natural gas, by the producers in Texas Railroad Districts 7-C and 8 and New Mexico counties Lea, Eddy and Chavez which are respondents herein, that are above the applicable area rates prescribed herein, have not been shown to be just and reasonable or otherwise lawful under the provisions of the Natural Gas Act and should be disallowed, and refunds should be required as hereafter provided.

(4) The just and reasonable rates for past, present and proposed sales of natural gas to which this order applies are the applicable area rates set forth in ordering paragraphs (A) and (B) below.

(5) It is necessary and appropriate and in the public interest to establish minimum rates as provided in ordering paragraph (G) for all natural gas produced in the Permian Basin.

(6) Contracts providing for rates in excess of the applicable just and reasonable rates determined herein or below the minimum rates herein established are in that respect unjust and unreasonable.

(7) The moratorium until January 1, 1968, upon the filing of price increases above the just and reasonable rates established herein is necessary to the practical administration of area rate ceilings and the effective price regulation of natural gas producers.

(8) Except as herein granted the exceptions to the initial decision and proposed order should be denied.

The Commission orders, pursuant to Sections (4e) and (5a) of the Natural Gas Act

(A) *The Base Area Rates*

The following base area rates are hereby established, as of the effective date hereinafter defined, as the just and reasonable rates for sales of gas for resale in interstate commerce by the respondents in this proceeding, subject to any applicable adjustments for quality as provided in ordering paragraph (B) hereof:

(1) For new gas-well gas, as defined in this opinion, sold and to be sold pursuant to contracts executed on or after January 1, 1961, and any residue gas derived therefrom:

a. In Texas Railroad Districts No. 7-c and 8 — *16.5 cents per Mcf* (at 14.65 psia).

b. In Lea, Eddy and Chaves Counties in New Mexico — *15.5 cents per Mcf* (at 14.65 psia) plus the applicable state and local production taxes in effect on the effective date hereinafter defined.

(2) For gas-well gas, sold and to be sold pursuant to contracts executed before January 1, 1961, and any residue gas derived therefrom, and for all casinghead gas and any residue gas derived therefrom sold and to be sold:

a. In Texas Railroad Districts No. 7-c and 8—*14.5 cents per Mcf* (at 14.65 psia).

b. In Lea, Eddy and Chaves Counties in New Mexico—*13.5 cents per Mcf* (at 14.65 psia) plus the applicable state and local production taxes in effect on the effective date hereinafter defined.

(B) *Quality Standards and Adjustments to the Base Area Rates*

(1) The base area rates fixed in ordering paragraph (A) herein shall be adjusted for any deviations from the standards for pipeline quality gas in Texas Railroad Districts Nos. 7-c and 8, and in the New Mexico counties of Lea, Eddy and Chaves, which are hereby established as follows:

a. *Carbon Dioxide:* Pipeline quality gas shall contain not more than 3 percent carbon dioxide by volume.

b. *Hydrogen Sulphide:* Pipeline quality gas shall contain not more than 10 grains of hydrogen sulphide per Mcf of natural gas at 14.73 psia and 60° F.

c. *Total Sulphur:* Pipeline quality gas shall contain not more than 200 grains of total sulphur per Mcf of natural gas at 14.73 psia and 60° F.

d. *H_2O:* Pipeline quality gas shall contain not more than .009 pound of H_2O per Mcf of natural gas at 14.73 psia.

e. *Other Impurities:* Pipeline quality gas shall contain no oxygen, dirt, dust, gum, or other impurity in sufficient amounts to require the buyer to incur processing costs to eliminate such im-

purities in order for the gas to meet either customary commercial standards or the customary requirements of any of the interstate pipelines in the area.

f. *Pressure:* Pipeline quality gas shall be delivered at a pressure of not less than 800 pounds per square inch.

g. *Btu Adjustment:* (For new gas-well gas only). The maximum standard will be 1,050 Btu's per cubic foot at 14.73 psia and 60° F. and the minimum standard will be 1,000 Btu's per cubic foot at 14.73 psia and 60° F. Upward and downward

adjustments of the base area rates will be permitted on a proportional basis as specified at pages 99-100 of this opinion if the Btu content exceeds the maximum standard or is below the minimum standard.

(2) When a purchaser buys gas which deviates from the quality standards established in subparagraph (1) above, the base area rate fixed in ordering paragraph (A) shall be adjusted for any deviations from such standards as follows:

a. The applicable base area rate shall be adjusted downward by the net cost of processing the gas to bring it up to standard.

(i) If the processing is performed by the purchaser, a reasonable return upon the net investment should be included as part of the processing cost incurred in bringing the gas up to pipeline quality.

(ii) If processing reduces the volume of the gas, the purchaser shall pay for only the volume remaining after processing.

b. The applicable base area rate for new gas-well gas only shall be adjusted downward or upward by the amount of any applicable Btu adjustment and by the concomitant amount of any saving or additional expenses to the seller from any reduction or increase in taxes or royalty payments resulting therefrom.

(C) Applicable area rate, as that term is used herein, shall mean the base area rate established by ordering paragraph (A) or the rate determined after adjustment, if any, of that base area rate for the deviations from the quality standards established by ordering paragraph (B).

(D) The applicable area rate as defined in ordering paragraph (C) above, shall be effective from and after the effective date hereinafter defined and any amounts collected in excess thereof from and after such effective date shall be subject to refund plus interest at 7 percent. In addition,

with respect to the rates involved in the Section 4(e) proceedings set out in Part III of Appendix A, the applicable area rate as defined in paragraph (C) above, shall be effective from the date such Section 4(e) rates were collected subject to refund and all amounts collected under those Section 4(e) rates in excess of the applicable area rate shall be subject to refund from the date such excess was collected plus interest at the rate

specified in the respective Section 4(e) proceeding, in accordance with the provisions of ordering paragraphs (I) and (J) herein.

(E) Within 45 days from the effective date hereinafter defined each respondent shall file a supplement to each applicable rate schedule, effective as of the effective date hereinafter defined, reflecting any reductions required to bring any or all of its rates into conformity with the applicable base area rate established by ordering paragraph (A) herein.

(F)(1) Within 90 days from the effective date hereinafter defined, each respondent listed in Part I or Part III to Appendix A (except those exempted by subparagraph (3) hereof) shall file with the Commission a statement in conformity with Appendix D to this opinion for each rate schedule such respondent has on file with this Commission for the sale of natural gas produced or sold within Texas Railroad District No. 7-c, Texas Railroad District No. 8, or the New Mexico counties of Lea, Eddy or Chaves. Such statement shall set forth either that the gas accords with all pipeline quality standards established herein, or in which respects the gas deviates from the particular quality standards established herein; the agreed cost to the purchaser of processing the gas to bring it to the pipeline quality standards established herein with respect to each quality deviation; any upward or downward Btu adjustment for new gas-well gas; and the resulting applicable area rate for the gas. Such statement shall be signed by both the seller and the purchaser. If the seller and the purchaser

are unable to agree upon any or all of the particulars entering into the computation of the applicable area rate, the seller shall file the statement herein required which shall indicate the absence of agreement and supply the information required to compute the applicable area rate as well as the contentions of the parties with respect to the quality and amount of the adjustment for any item in dispute. The purchaser may file a separate statement setting forth its views within the period herein provided.

(2) The statement filed hereunder which reflects full agreement between seller and purchaser shall be deemed accepted by the Commission unless the Commission, within 60 days after such filing, shall otherwise order. In the event of disagreement between the seller and purchaser or, where the Commission otherwise determines that the statement filed is inconsistent with the provisions of ordering paragraph (B) herein, the Commission will, after appropriate proceedings, prescribe the applicable area rate to be applied as of the effective date hereinafter defined.

(3) Any respondent listed in Part I or Part III to Appendix A is exempt from filing the statement required by subparagraph (1) hereof for any sales which are "small producer sales" as defined in the rule providing for small producer certificates proposed this date, if within 45 days from the effective date hereinafter defined such respondent files the information requested in Appendix E to this

opinion required to qualify for a small producer certificate for such sales. If the Commission subsequently finds that such a producer does not qualify as a small producer such applicant shall be required to file the statement required by subparagraph (1) hereof within 90 days after any such Commission finding.

(G) *Minimum Rates*

(1) Minimum rates for natural gas produced in the Permian Basin area are hereby established as follows:

For gas meeting all pipeline quality standards *9 cents per Mcf* at 14.65 psia.

For gas not meeting all pipeline quality standards as established herein *9 cents per Mcf* reduced by the amount of any adjustments for quality as provided in ordering paragraph (B).

(2) All respondents who are currently making sales subject to the jurisdiction of this Commission and produced in Texas Railroad District No. 7-c, Texas Railroad District No. 8, or any of the New Mexico counties of Lea, Eddy or

Chaves, are hereby authorized to apply for increases to the minimum rates fixed in subparagraph (1) hereof. Such applications shall be accompanied by the information required in Appendix D to this opinion, signed by the seller (or the agent or operator). Increases to the established applicable minimum rate will be granted notwithstanding

contractual provisions to the contrary which are hereby modified *pro tanto*.

(H) *Moratorium on Rate Increases*

No respondent listed in Part I and Part III of Appendix A to this opinion shall file any change in rate providing for a price in excess of the applicable area rate prior to (1) subsequent order of the Commission in this proceeding permitting such filing or (2) January 1, 1968, whichever is earlier. All contracts of the respondents listed in Part I of Appendix A relating to sales of natural gas subject to the jurisdiction of this Commission and produced in Texas Railroad District No. 7-c, Texas Railroad District No. 8, or any of the New Mexico counties of Lea, Eddy or Chaves shall be deemed amended, pursuant to Section 5(a) of the Natural Gas Act, by the inclusion of the following language:

> From the effective date of the order of the Federal Power Commission in the Permian Basin Area Rate Proceeding, AR61-1, (therein defined as September 1, 1965), until January 1, 1968, no increase in rates may be filed, except in compliance with a specific order of the Commission for a rate in excess of the applicable area rate as determined pursuant to said proceeding or pursuant to later order of the Commission.

(I) *Refund Reports*

Within 120 days from the effective date hereinafter defined a refund report shall be filed with this Commission in triplicate by each respondent involved in one or more of the Section 4(e) proceedings set out in Part III of Appendix A to this opinion. The report shall set forth

the following information (if more than one rate schedule is involved the respondent shall supply the information for each schedule separately):

(i) The rate collected during the period subject to refund, and the periods during which each rate was collected.

(ii) The volume of gas sold at each such rate.

(iii) The difference between the total amount collected during the period subject to refund and the applicable area rate as defined herein. If seller and buyer do not agree upon the items necessary to the computation of said rate, the seller shall make this computation on the basis of the information supplied by the seller in the statement required by ordering paragraph (F) subject, however, to the terms of subparagraph (2) thereof.

(iv) The interest, at rates as specified in each Section 4(e) proceeding, on the amount collected during said period in excess of the applicable area rate. The interest shall be calculated to the date of the report.

(J) *Treatment of Refunds*

Each respondent shall retain the amounts shown in the report required under ordering paragraph (E) subject to further order of the Commission directing the disposition of those amounts. If a respondent elects to commingle these retained refunds with its general assets and use them for its corporate purposes, and after notice to the Commission it is specifically authorized so to do, it shall pay

interest thereon at the rate of 4.5 percent per annum on all funds thus available from the date of the filing of the refund report to the date on which they are paid over to the person ultimately determined to be entitled thereto in a final order of the Commission. If a respondent elects to deposit the retained refunds in a special escrow account, the respondent shall tender for filing on or before the date of the filing of the refund report an executed Escrow Agreement, conditioned as set out below accompanied by certificate showing service of a copy thereof upon each of its jurisdictional customers. Unless notified to the contrary by the Secretary within 30 days from the date of filing thereof, the Escrow Agreement shall be deemed to be satisfactory and to have been accepted for filing. The Escrow Agreement shall be entered into between respondent and any bank or trust company used as a depositor for funds of the United States Government and the agreement shall be conditioned as follows:

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(1) Respondent, the bank or trust company, and the successors and assigns of each, shall be held and formally bound unto the Federal Power Commission for the use and benefit of those entitled thereto, with respect to all amounts and the interest thereon deposited in a special escrow account, subject to such Agreement, and such bank or trust company shall be bound to pay over to such persons or persons as may be identified and designated by final order of the Commission and in such manner as may

be therein specified, all of any portion of such deposits and the interest thereon.

(2) The bank or trust company may invest and reinvest such deposits in any short-term indebtedness of the United States or any agency thereof or in any form of obligation guaranteed by the United States which is respectively payable within 120 days as the said bank or trust company in the exercise of its sound discretion may select.

(3) Such bank or trust company shall be liable only for such interest as the invested funds described in Paragraph (2) above will earn and no other interest may be collected from it.

(4) Such bank or trust company shall be entitled to such compensation as is fair, reasonable and customary for its services as such, which compensation shall be paid out of the escrow account to such bank or trust company. Said bank or trust company shall likewise be entitled to reimbursement for its reasonable expenses necessarily incurred in the administration of this escrow account, which reimbursement shall be made out of the escrow account.

(5) Such bank or trust company shall report to the Secretary quarterly, certifying the amount deposited in the trust account for the quarterly period.

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(K) No respondent shall file hereafter any change in rate providing for a price in excess of the applicable area

where the contractual right to such filing is based upon any contractual provision which would not be permitted by subsections (a), (b) and (c) of Section 154.93 of the Regulations under the Natural Gas Act.

(L) Notwithstanding the issuance of this final order, these proceedings shall remain open for such further action as may be necessary with respect to individual respondents and such other action as may be necessary in the premises.

(M) Except as herein granted the exceptions to the initial decision and proposed order are hereby denied.

(N) The date of issuance of this opinion and order within the meaning of Section 19(a) of the Natural Gas Act is the date shown on page one of the opinion immediately below the title thereof. The term "effective date hereinafter defined" (as it is used in the ordering paragraphs herein) is September 1, 1965.

By the Commission. Commissioner O'Connor filed a separate statement concurring and dissenting on limited issue.

Commissioner Ross filed a separate statement concurring and dissenting on limited issue.

(SEAL)

Commissioner Black filed a separate statement concurring.

Commissioner Bagge not participating.

/s/ J. H. GUTRIDE
Joseph H. Gutride,
Secretary.

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Area Rate Proceeding Claude E. Aikman, *et al.* North Central Oil Corporation, (Operator), *et al.*	Docket Nos. AR61-1 G-18466, *et al.* CI60-435, *et al.*

O'CONNOR, Commissioner, *concurring and dissenting on limited issue:*

(Issued August 5, 1965)

The Commission's decision issued today is a significant event in the evolution of our area rate policies, and, on the basis of the record before us, it establishes just and reasonable rates for natural gas producers in the Permian Basin. It is my opinion that our extensive investigation has been synthesized into a meaningful system of regulation, and, for the purposes of our initial area proceeding, I endorse the consideration of costs. The cost analysis we utilize is a useful and proper determination of the financial requirements of the industry, and the results are defensible. I therefore concur in the Commission's opinion, including, of course, the procedures for implementation of the rates we establish; my dissent is limited to one issue.

While I join for present purposes, I am convinced that the experience gained in this costly and expansive proceeding justifies a simplification of the trial and disposition of future area proceedings. Price control being our objective, it is clear that the interests of producers and consumers can be adequately protected under expedited procedures based upon reasonable market prices. The record in this case fully establishes that the contract price

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at which most producers are able and willing to operate is just and reasonable. This standard provides the measure of inducement that has been successful in providing an excellent source of energy for use in all sectors of the Nation. Thereby, any policy that focuses on profits realized, as recommended by some parties before us, would be avoided, and the focus would be on supply elicited, which policy we here endorse. Furthermore, it is preferable to tolerate such imperfections as might result from area regulation in the interest of avoiding complicated cost-plus methodology.

The contract price is the measure of inducement. Composite costs best serve as a check on average field prices to preclude significant price departures. Our judgment should rest primarily on the market place where we can rely on competition to determine just and reasonable rates. In the hope that they will become the rule, I hereby express my additional views and recommendations.

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PRELIMINARY CONSIDERATIONS

In 1954 the Supreme Court made the unexpected determination that this Commission has jurisdiction over the interstate sales of natural gas producers and that it has a corresponding obligation to regulate those sales in the public interest. For fourteen years prior to that decision the Commission had repeatedly rejected the jurisdictional argument, and, due to the obvious difficulty of the task, the Commission had regularly recommended legislation

granting only limited regulation over producers. In 1956 the Congress acquiesced in this view by approving such legislation, only to see it rejected by Presidential veto for reasons totally removed from the merits of the bill itself. Today, more than a quarter-century after the Natural Gas Act was adopted, and eleven years after this Commission was granted jurisdiction over producer sales, a decision has been reached which accommodates to an intent that prices for natural gas be regulated. However, although the law compels an embarkation into price control during peacetime, it does not dictate a single methodology, and herein lie my separate recommendations for future area decisions.

The task of selecting a reasonable approach to regulation that will reflect the practical necessities before us is a difficult one, but cognizance of several factors will make an acquittal of the duty more meaningful. The production of natural gas is an industry in which there is an intricate interplay of special market circumstances. Pipeline control over field prices presents awesome monopsonistic powers. Problems of waste and correlative rights compel state conservation regulation. Shared problems with oil lead to an overlapping of economic interests. Public utility characteristics at the transmission and distribution end go so far as to generate demands for price controls over the producing industry. The absence of traditional public utility characteristics in the production of natural gas presents problems that are directly antithetical to the transmission or distribution of the commodity; there is not the same direct relationship between investment and

output at the crucial focus of the individual company, and there is certainly no legal obligation to provide new services. Reflecting these multifarious consideration, Justice Jackson observed, "If natural gas rates are intelligently to be regulated we must fit our legal principles to the economy of the industry and not try to fit the industry to our books." *F.P.C. v. Hope Natural Gas Co.*, 320 U.S. 591, 650 (1944). In that opinion he emphasized,

> It is necessary to a "reasonable" price for gas that it be anchored to a rate base of any kind? Why did courts in the first place begin valuing "rate bases" in order to "value" something else? The method came into vogue in

> fixing rates for transportation service which the public obtained from common carriers. The public received none of the carrier's physical property but did make some use of it. The carriage was often a monopoly so there were no open market criteria as to reasonableness. The "value" or "cost" of what was put to use in their service by the carrier was not a remote or irrelevant consideration in making such rates. Moreover, the difficulty of appraising an intangible service was thought to be simplified if it could be related to physical property which was visible and measureable and the items of which might have market value. The court hoped to reason from the known to the unknown. But gas fields turn this method topsy turvy. Gas itself is tangible, possessible, and does have a market and a price in the field. The value of the rate base is more elusive than that of gas. It consists of intangibles — leaseholds and freeholds — operated and unoperated — of little use in themselves except as rights to reach and capture gas. The value lies almost wholly in predictions

> of discovery and of price of gas when captured, and bears little relation to cost of tools and supplies and labor to develop it. Gas is what Hope sells and it can be directly priced more reasonably and easily and accurately than the components of a rate base can be valued. Hence the reason for resort to a roundabout way of rate base price fixing does not exist in the case of gas in the field: 320 U.S., 647-48.

Regulatory authority must be employed as the characteristics of the industry dictate. Congress and the courts have refused to confine permissible principles of procedure to a narrow corridor; by granting the Commission flexibility, they implicitly recognized the wisdom of the Justice's words.[1]

By these distinct considerations, the purpose and the method of price regulation is presented in its proper perspective, and they should dictate the results required. Where a compulsory service obligation exists the only regulatory problem is to appraise a service that must, of legal necessity, be rendered. Where the output is direct and constant, the value of the service thus performed, in terms of the allowed rate, can legitimately be referenced to a reasonable yield on the actual costs involved. In the absence of this obligation, however,

the role of appraising the services performed assumes a decidedly different function: the problem becomes that of

[1] See, e.g., *Wisconsin* v. *F.P.C.*, 373 U.S. 294 (1963); *Colorado Interstate Gas Co.* v. *F.P.C.*, 324 U.S. 58 (1945); *F.P.C.* v. *Natural Gas Pipeline Co.*, 315 U.S. 575 (1942); *Bel Oil Corp.* v. *F.P.C.*, 255 F.2d 548 (5th Cir. 1958); *Forest Oil Corp.* v. *F.P.C.*, 263 F.2d 622 (5th Cir. 1959).

fixing a price based, not only upon what must be performed, but primarily upon what will induce the product. The regulatory emphasis shifts. It is not so much actual cost as it is market cost; not only prudent return but incentive prices; not just cost of service but also cost of supply. These multifarious considerations are so well established that there should be no need for further discussion. They were made explicit in our decision to focus on area rate-making and have been consistently reaffirmed. *Phillips Petroleum Company* 24 F.P.C. 537, 542-548 (1960); *aff'd*, 373 U.S. 294, 308-310 (1963). That decision compels thorough consideration of the factors that determine a reasonable market price.

It has been argued that *en masse* cost proceedings contain an inherent incentive for low cost producers since their profits are limited only by ceilings premised on much higher costs. Group cost proceedings may offer more incentives than individual proceedings, but if the history of pipeline production and its regulation by this Commission on an individual cost basis is any indication, cost regulation as a general principle in utility regulation does not provide the necessary system. By such control, there has been a 25 per cent decrease in the ratio of actual pipeline production over a six-year period: in 1957, pipeline production was 11.69 per cent of purchases; in 1958, 10.56 per cent; in 1959, 10.87 per cent; in 1960, 10.38 per cent; in 1961, down to 9.57 per cent; and in 1962, only 8.78 per cent. See *Sales by Producers of Natural Gas to Natural Gas Pipeline Companies* (F.P.C. 1963). These statistics are for individual companies as composited on an annual basis.

It has also been argued that, if total industry costs plus a reasonable return are recovered, then gas will continue to be found. Total costs are not recovered under group cost regulation; the higher cost producers, which must be considered in any statistical compilation, will still not be made whole. Moreover, gas is found by the individual decisions and acts of thousands of producers. To them, incentives must relate to profits available in other sectors of the economy. If the maximum price any one producer can obtain from his production is insufficient, as he might determine *vis-a-vis* his own interests and alternative investments, it is of little concern to him that the ceiling was premised on the larger percentage of the industry's costs. So long as there is a reasonable likelihood that his prices will be reduced below his contract terms or his certificate conditions, he will not have the necessary incentive to commit funds for further exploration.

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I emphasize, in full agreement with our opinion, that the area rates we are to determine have a single, overriding purpose: to control the available supply of natural gas; and those rates have but one utilitarian function: to be high enough, but only high enough, to accomplish this policy function. In the context of area pricing, just and reasonable rates can best be used as a measure to elicit the necessary supply. So viewed, price control is the overriding policy. The function should be accomplished, and the standard should be employed, in the most direct and least dilatory manner possible.

REGULATION BASED SOLELY ON COSTS

The Commission places primary reliance for its answer in this initial case upon cost-plus regulation. This accepted formulation is little more than individual cost of service applied on an area basis to an averaging of composite costs. In making this determination, we must grapple with Gordian problems that do not readily accommodate to precise disentanglement; for our purposes here, cost analysis defies mathematical logic. Nevertheless, the focus in this proceeding on such costs make it both necessary and proper that we determine the financial requirements of the industry.

Costs as a Basis for Comparison

The major emphasis in the Commission opinion on cost-plus regulation appears to stem from a conviction that costs *must always* be the primary basis for regulation. I believe we have more flexibility, particularly for future proceedings, than is suggested there. The leading authority on this issue is *F.P.C.* v. *Hope Natural Gas Company,* 315 U.S. 575, where the Supreme Court declared:

> It is not the theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unjust or unreasonable, judicial inquiry is at an end. The fact that the method employed to reach that result may contain infirmities is not then important.

The tenor of the above quotation supports the general proposition that regulatory agencies are to be accorded a strong presumption of validity in determinations that

must be based largely on commission expertise. Certainly producer regulation qualifies as a subject matter in which there should be large scope for Commission innovation and adaptation to the economic facts of life in the industry. The Commission opinion, in my view, charts too narrow a course for the future. Cases such as *City of Detroit* v. *F.P.C.*, 230 F. 2d 810 (1956), where the D. C. Circuit Court

reversed a Commission determination which would have allowed a pipeline the field price for its purchases of natural gas from an affiliated producer, do not bind us to costs alone. The Commission had there sought to avoid the complicated and time-consuming "rate-base" method, which is presently relied upon for the flowing gas price albeit on an area basis. The circuit court reversed, holding that the purposes of the Natural Gas Act require that costs be considered; however, the opinion emphasized that this was to be regarded as no more than a starting point. Thus, the Court there stated:

> . . . though we hold that method [the rate base or cost of service method] not to be the only one available under the statute, it is essential in such a case as this, that it be used as a basis of comparison. It has been repeatedly used by the Commission, and repeatedly approved by the courts, as a means of arriving at lawful — "just and reasonable" rates under the Act. Unless it is continued to be used at least as a point of departure, the whole experience under the Act is discarded and no anchor, as it were, is available by which to hold the terms "just and reasonable" to some recognizable meaning.

The above language was relied upon by the Fifth Circuit in another proceeding, *Bel Oil Corporation* v. *F.P.C.*, 255 F. 2d 548 (1958), where that court was faced with an allegation by certain producers that the Commission should base just and reasonable rates on field prices. The court rejected this contention, saying:

> We cannot agree [to] the proposition that the evidence thus far adduced makes out a *prima facie* case of reasonableness of the contract price of 16 cents. We do not hold that the evidence of field price is irrelevant. We do hold that evidence of unregulated prices in the field is not sufficient to warrant a finding by the Commission that a price comparable to them is just and reasonable within the intendment of the Natural Gas Act. *Id.*, at 553.

The Court further observed:

> The regulation of the prices at which thousands of "natural gas companies" may sell to the pipeline companies is a difficult one at best. It is a field which in many respects requires new formulas to test what is just and reasonable.

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Rebutted in efforts to rely solely on contract prices, the Commission commenced the seemingly interminable task of determining just and reasonable rates to be allowed on an individual company cost of service basis for the country's major producers of natural gas. Realizing the futility of the individual cost approach, the Commission made the necessary determination that area rates be utilized. Significantly, the decision marked a step away from the individual company costs; the emphasis shifted to other economic indicia. New formulae for public util-

ity regulation were necessary. It became possible under area pricing that some producers might not be able to operate under ceilings; it also raised the possibility that many producers would receive high rates of return simply because of the success of their operations. The departure signalled the demise of cost-plus regulation for natural gas producers. Recognition was accorded the fundamental difference that exists between the producer of a commodity and the seller of a service. The latter is readily amenable to utility regulation; the former clearly is not. Significantly, the same court that decided *City of Detroit* affirmed the departure from costs in the *Second Phillips* litigation. In 303 F. 2d 308 (D.C. Cir. 1961) Chief Judge Prettyman, author of *City of Detroit,* declared:

> . . . But what of a fair price for a commodity bought and sold by a merchandiser? Almost the whole of the economics of merchandising differs from the economics of public utility service. Are the just and reasonable prices of such a merchandiser limited to fair returns on his own investment and prices paid by him (and, if so, what investment and what prices), or are those prices reasonably measured by the fair prices for the product as measured by the open competitive market for the product, evaluated by Commission expertise and data on the whole of the market operation? Either criterion is a method of regulation. It seems to us that the choice must lie with the Commission. *Id.,* at 388.

In turn, the Supreme Court affirmed the area approach, 373 U.S. 294 (1963). Significantly, it there declared:

> We recognize the unusual difficulties inherent in regulating the price of a commodity such as natural gas. We respect the Commission's considered judg-

> ment, backed by sound and persuasive reasoning, that the individual company cost-of-service method is not a feasible or suitable one for regulating the rates of independent producers. We share the Commission's hopes that the area approach may prove to be the ultimate solution. *Id.*, at 310.

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Although repeating assurances at oral argument that "composite cost-of-service data" would be considered, the Court went on to say that *City of Detroit*, insofar as it required cost regulation, is to be distinguished from area pricing because the circuit court did not have before it any questions relating to the area rate method. This precedent leads inexorably to the conclusion that, even though some consideration of costs may be required for an initial area pricing formula, the cost approach need not, in circumstances of workable competition, be the governing methodology. Nevertheless, five years after the area approach was initiated in *Second Phillips*, and over twenty years after the Court observed that "he who would upset the rate order under the [Natural Gas] Act carries the heavy burden of making a convincing showing that it is invalid because it is unjust and unreasonable in its consequences." . . . *F.P.C.* v. *Hope Natural Gas Co.*, 320 U.S. 591, at 601 (1944), this Commission retains its attachment to cost-plus. In the light of compelling authority, it must be concluded that fears of judicial review need not be entertained to preclude Commission departure from strict adherence to cost-plus. In this proceeding there has been an extensive investigation into the operations of producers, with all parties having received a thorough opportunity to

present their separate views and to review the evidence presented by others. Beyond a doubt, with due consideration being accorded the many difficulties inherent in any cost analysis of a joint product, it is clear that the prices adopted today bear a close and substantial relation to the weighed average prices negotiated in the field. The cost-plus rate and the negotiated contract rate fall within that zone of reasonableness that is essential to regulation. Therefore, it is not required in future proceedings that costs be the beginning and the end of just and reasonable rates. The time is ripe to abandon costs as the sole referential. Among the alternatives, competition has been shown to be sufficient to provide an appropriate and compelling measure of just and reasonable rates.

Inherent Limitations in Cost-plus Regulation

Cost-plus regulation alone is not an objective, independent determinant for just and reasonable prices for producers. Any determination upon evidence of costs will necessarily depend on numerous pragmatic adjustments that will, without consideration in detail of other relevant factors, permit a certain amount of variation that could otherwise be controlled. It is no difficult matter to appreciate the problem. Staff concedes that "costing for producers of gas is not, and likely never will become, as precise as is customary in utility regulation." The major inherent difficulties are fourfold.

Fundamentally, the factual and statistical presentations relied upon in the main opinion are but estimates. There

are immense difficulties in the collection, selection, and presentation of data. Voluminous questionnaires are issued, but many go unreturned. Staff Appendix data in the largest of the five size categories is based on 93.8 per cent of the producers. In the next largest group only 30.9 per cent are available. The percentages are dropped drastically to 8.0 per cent in the third group, to 2.7 per cent in the fourth, and to but 0.8 per cent in the smallest. Although the excellent response in the largest category does provide good area cost coverage, there is a notable exception by the absence of crucial exploratory drilling costs. Specifically, unrecorded dry holes are of necessity incomplete. Any meaningful anticipation of probable accuracy is weakened by an absence of fully reliable statistical verity. Perhaps these deficiencies could be cured in the future, but the precipitous decrease for available questionnaire data on the small producer groups presents more fundamental problems, particularly since the small producers drill the greater proportion of exploratory wells. The smaller producers operate on extremely limited resources and are thus less likely to maintain books that would be adequate to provide meaningful replies. While 67 of 68 Appendix B questionnaire responses for the second largest group are acceptable for compositing purposes, 46 of the 105 Appendix C responses were inconsistent or incomplete to the extent that their data was entirely excluded. Consequently, as sales and production volumes decrease data credibility likewise decreases. Exhibit 255, among others, indicates there is an exact inverse relationship between sales volumes and per unit costs; as the former decrease, the latter increase. This statistical inac-

curacy means that primary reliance on questionnaire data places the small producer — the one most likely to be undercut through *enmasse* normative costing — in a triple squeeze: due to the high cost of compilation, a low percentage can submit cost data; a high percentage of the data submitted must thus be rejected; and such responses as finally filter into a composite exhibit must be discredited for low coverage on a voluntary basis.

Despite these inherent deficiencies, the issuance of the questionnaires is not inutile. To the contrary, their submission has been of notable assistance in arriving at rates which are just and reasonable, and in establishing, as evidenced in our opinion, that negotiated field prices are within the permissible zone of reasonableness, even from a cost perspective.

Of necessity, the Commission had to supplement questionnaire data by amplifying the information available from various published sources. Although this reinforces some aspects of

data reliability, other problems arise in proportion. The separate publications are usually limited to the very large operators, and are thus even more restricted than under the questionnaire responses. Coverage of these outside sources is usually national and international, so that expenditures are presented in broad categories that portray many meaningful items in a single dollar total; consequently, specific cost items that should require special regulatory treatment cannot be separately identified for

the Commission's purposes. As various sources are necessarily utilized, approximation of these unknown components is effectively prevented by the obscure or overlapping categorizations used by each source. Statistical probability thus declines and, although such cost analysis provides a "zone of reasonableness" within which the required pragmatic adjustments can properly be made, there is no precise objective standard for the purposes of the industry.

After the cost components are adopted, the circular ceremony known as cost allocation begins. We have avoided some of the pitfalls, but our reliance on even the semblance of allocation requires that we exercise our judgment within a fairly broad range of rates. By definition, allocations occur because certain costs cannot be directly identified with certain functions of the various identifiable products or assets, and allocated costs thus present a distinct existence apart from directly ascertainable costs. Where the ratio to total industry costs is small, the gaps are insignificant; however, as the ratio increases, both the costs and the resulting rates, to the extent directly transferred, become less reliable and more subject to adjustment. As the speculative base becomes more pronounced, the choice of allocation formulae can produce a wider range of rates, but the logical relationship between any resulting rate and the current costs of supply becomes even more remote. Although the courts may have declared that "It is not the theory but the impact of the rate order which counts," I do not believe that merely because the results reached today are reason-

able and have a valid reference to the prevailing market price at the well-head that cost-plus should be employed in the future as the sole referential. The imprecise determinations can only be a transcendent command unduly complicating later proceedings, and the analytic principles evoked can have but the validity of a foregone conclusion.

The difficulties involved in allocations are not hard to appreciate. The allocations problem confronted by the Commission is that of attributing legitimate, but separate, costs to a largely joint product. According to witness Sherwin,

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the costs attributable to associated gas are 100 per cent joint, as that term is technically employed, and, for non-associated gas, 31 per cent joint and 24 per cent shades of joint and common. Thus, even for non-associated gas, only 45 per cent of the costs are directly attributable to the product committed to our jurisdiction. The Commission has previously stated the implications of this:

> While we must make allocations in all rate cases, the amounts involved in electric and gas pipeline cases have been comparatively small, and the allocations relatively simple. In the case of a producer, the amounts involved in the allocations of costs are major in size and extremely difficult to make. The result is that a producer actually could become bankrupt, or could make enormous profits, depending merely upon the methods of allocation used. 24 FPC, at 543-544.

Strict adherence to allocation formulae would produce a spectrum of rates so wide and variant as to lend a sophist's support for the extremes, and as a practical matter to be capable of producing clearly unrealistic results. In such a case, as well as in the case of prescribed rates that come to rest somewhere between the extremes, the supposedly independent determination of legitimate costs is actually based upon pragmatic adjustments of either the formulae employed or, in a guise of expertise and trending, of the deceptively precise mathematical resultants. This certainly is no well-guarded secret:

> When an unrealistic result is reached, the formulae for allocations must be changed, in order to bring about a reasonable result. The allocation methods then become a means of supporting a result already arrived at, rather than a means of arriving at a result which was previously unknown. *Id.*, at 544.

Finally, even after statistical costs are collected, compiled, selected, allocated, and invariably trended and modified, they must still be related to reserve additions before the desired costs per Mcf can be found. An understatement of reserves found causes high per unit costs, and thus results in high rates. An overstatement has the reverse results. Despite the confidentiality attached by producers to their reserve figures, the industry's cooperation in this proceeding prompted them to submit a composite exhibit of estimated reserves for the Permian Basin. In addition, there are numerous published sources for reserves estimates. Nevertheless, such figures are no more than estimates, and their estimation entails a considerable degree of subjectivity. This is revealed on the

record before the Commission as was similarly disclosed in the investigation into Phillips' individual costs. See 24 FPC, at 544.

The statutory function of rate regulation is to arrive at reasonable results, and no criticism can be levelled at the attempt to stay within a zone of reasonableness. The use of composite figures to explain economic behavior is clearly a most useful analytic system; however, reliance on allocations, estimates, and other variations of expertise are not the only independent referentials that are desired or that can be utilized.

To the extent that cost analysis is productive of reasonable results, and with one exception our opinion today meets this judicial standard, it would be most helpful for our regulatory purposes if ascertainment of a producer's investment were to be presented on a basis conforming to sound accounting practices. The derivation of a return allowance is a three-step computation: first, ascertainment of the investment; second, determination of the period of time over which the investment is to be allowed a return; and, third, ascertainment of the rate of return. I concur in the Commission's determination on this issue because, on the record in this case, no other disposition is feasible. However, it appears that the yield concept deserves full consideration in future proceedings as a reasonable alternative that might be preferable to traditional methods.

In a 1963 publication by Arthur Andersen & Company, entitled *Accounting for Oil and Gas Exploration*

Costs, it is concluded that the present practice of the industry of expensing exploration and development costs as incurred is in discord with accounting and economic principles. Written for the limited purpose of discussion and study, the publication recommends that leasing, acquisition, carrying, drilling, geological, and other such costs, as well as general and administrative costs related to exploration and overhead, be capitalized and later amortized on an overall unit-of-production basis as production occurs. It states, "[s]uch aggregate costs include nonproductive exploration costs which, in our opinion, are capital in nature," and later, "[t]hey should be capitalized since they are just as much a part of the cost of the reserves found as are the lease and well equipment on the producing wells." The pamphlet recognizes, however, that ". . . appropriate recognition should be given to such current reductions in income taxes as may result from the current deduction of such capitalized costs for income taxes as incurred. This is essential to a proper determination of costs."

The recommendation in the pamphlet may also be sound for regulatory purposes. At least, as recommended by Staff witness

Spain, that portion of it which advocates full cost accounting for all finding expenditures should be thoroughly explored. Any lesser treatment is a refusal to recognize the full cost of acquiring productive assets. Such cost accounting has been undertaken on a very limited basis by the industry, and it appears that the results have pro-

vided more accurate knowledge of the functioning of the industry and of the results of expenditures. Without going into detail at the present, I believe the true yield method may be shown not to change the rates here established. In any event, it is not possible to utilize this control for our decision today: the record is not adequate; the various recommended returns are not directly transferable, and the industry has not generally accepted the principles involved.

AN APPROPRIATE BASIS FOR DECISION

These limitations inherent in cost-plus producer regulation do not, however, spring only from the allocations and adjustments, nor only from the inherent difficulties of data collection, selection, and compilation, nor only from the resulting deficiencies in the construction of a legitimate costing model, nor only through deemphasis of available reserves estimates. I believe the facts in this case reveal that in the future the Commission need not be confined to cost-plus regulation. The accusation of "drastic inflationary cycles" in wellhead prices in the last twenty years stands rebutted. As a matter of general principle, it is not sound to argue that cost-plus regulation cannot be supplemented because the rise in wellhead prices, experienced in the recent past, was due to producer-dictation of contract prices; that those prices were grossly in excess of cost trends; further, that the wellhead price increase was directly reflected in burner tip increases, albeit four-fold that at the wellhead; and, finally, that any attempt to consider factors in addition to cost-plus regulation would constitute an abdication of

responsibility, and would result only in another round of similar, allegedly violent, price jumps.

The propriety of the price rise since 1945

Any detailed discussion of the accusation of price-dictation by producers will not be undertaken here;[2] however, long

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experience with the industry is convincing that, where price dictation exists, it is seldom with the seller. All available information and discussion lead persuasively to the conclusion that field prices are set after vigorous bargaining within a context of numerous restrictive economic forces. More particularly, in the Permian, there has been an essentially monopsonistic environment whereby the transmission company in a particular field would set, on a unilateral basis, the fixed, maximum rate for natural gas in the area. Accomplishing this unilateral price-dictation is particularly possible for a company free of economic constraint. This was the situation for El Paso Natural Gas Company. El Paso not only purchases over 70 per cent of the interstate Permian gas, but it also produces over 15 per cent of its total volumetric purchases. In this connection it should be noted, as was established by the record in *United Gas Pipe Line Com-*

[2] The problems are well-documented in numerous professional journals and academic surveys. Reference is made particularly to MacAvoy's *Price Formulation in Natural Gas Fields,* (Yale University Press, 1962); Neuner's *The Natural Gas Industry; Monopoly and Competition in Field Markets,* (University of Oklahoma Press, 1960); and Cookenboo's *Competition in the Field Market for Natural Gas,* (The Rice Institute Pamphlet, 1958).

pany, Docket No. RP63-1, 31 FPC, at 55 (1964), wellhead prices are uniformly depressed in areas where pipeline production is prevalent. Nevertheless, many have argued that, if transmission companies had possessed any bargaining leverage, the recent rise in gas prices *could not have occurred*. This argument must be rebutted.

It is clear that the wellhead price increases of the 1950's began at levels not even remotely approximate to the cost or value of separately found reserves. No responsible authority disputes this position. As late as 1960, this Commission is on record that:

> . . . rigid adherence to the rate base method will, in many cases, price the producers' gas completely out of market. This fact is now abundantly clear: Regardless of variations in allocations methods, allowance for incentives, and other disputed factors, computations of the cost of natural gas which have been presented in the many cases before us show that natural gas has been, in most instances, substantially underpriced. 24 FPC, at 547.

When the Supreme Court ordered Commission jurisdiction over natural gas producers, gas was not paying its own way in the industry. The problem came to the forefront in 1948 when the Commission's *Natural Gas Investigation* established that gas was being wasted in enormous volumes, that it nevertheless had excellent value as a fuel, and that the most effective practice would be to establish a minimum price on sales of gas to pipelines in order to conserve the resource. It is paradoxical that, four years prior to its *First Phillips* decision, the Supreme Court should approve state-imposed minimum

wellhead prices for natural gas to the end that it would not be wasted. See *Cities Service Gas Co.* v. *Peerless Oil and Gas Co.*, 340 U.S. 179 (1950). This disparity between costs and past prices

is indicated by our opinion today.[3] If the analysis we utilize for new gas is applied to the average wellhead price for natural gas in 1947, the difference between the two is at least 2.4¢, with the average contract price being *below* the cost-plus figure. In 1947 gas sold at an average price of 6.0¢, but the Commission's present approach, if applied then, would have resulted in a price of 8.4¢. It was not until the late 1950's, according to the costs established today, that natural gas prices came to approximate the cost-plus rationale utilized by our opinion. Thus, the price rise of the 1950's resulted primarily from the gradual maturation of the natural gas industry into one where the product sold was paying a just return to the independent producer. Particularly anomalous, in view of allegations of "continuing inflation" of natural gas prices, is the fact that such an increased allowance to provide a return on investment and expenses is the least that should be accorded the producer as a result of his elevation to a "natural gas company" under the Act.

In addition to natural gas coming into its own, there were, in the main, four factors that led to increases. *First,*

[3] It is not possible to relate our present cost analysis in precise manner to past prices, primarily because of the absence of questionnaire data. Nevertheless, industry-wide statistics provide a meaningful basis for comparison.

the sudden rise in interstate demand necessitated, because of our regulatory standards, an equally sudden increase in reserve capacity with a concomitant market allocation to the higher usage. *Second,* the resultant of such demand was an activation of favored nation and spiral escalation clauses. *Third,* there was an extensive renegotiation of escalation clauses by pipelines in order to preclude such a repetition. *Fourth,* a competitive buyer's market existed temporarily when transmission companies entered new purchasing areas to negotiate contracts at prices somewhat above then extant market values. It is of special significance that wellhead increases occurred in the latter instance, particularly in the Permian Basin in the late 1950's, for it indicates that, without a competitive purchasing structure, producers are not able to achieve the higher prices. Thus, taking the average wellhead prices for the Permian in 1947 and 1956, the prices were 4.0¢ and 9.7¢ respectively, which are prices significantly less than the costs that have been established by this proceeding. By the rationale today utilized, this Commission could have established maximum prices of 7.2¢ and 12.5¢ in those two years, and the difference between the costs and what El Paso was then dictating amounts to prices some 30 per cent *below* the new gas ceiling that would have then been required.

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Furthermore, it must be emphasized that there is absolutely no support, apart from a so-called "anarchic inflation" allegation discussed hereinafter, that trans-

mission companies, even though they possess superior bargaining leverage, are, because of an alleged ability to shift the costs without concern, indifferent to using this leverage. This accusation has been clearly refuted, not only by the published authorities cited earlier, but by the record before us. Witness Mayer, who has participated for over thirty-five years in the negotiation of sales contracts for Phillips Petroleum Company which is the largest independent producer of natural gas in the United States, and has been a supervisor in the sales division since 1945, testified as follows:[4]

> Q: Turning first to matters of general rebuttal, I direct your attention to the question of the Examiner occurring during cross-examination of Mr. Frazier at Tr. 231/27,003, lines 1-4, concerning the degree of bargaining between pipelines and producers existing in the past and present in the Permian Basin and ask you to state what your experience has been in this regard.
>
> A: I have been intimately involved in negotiations with the pipeline companies in the Permian Basin for nearly twenty years. *I have yet to see the time that the negotiator for the pipeline didn't drive as hard a bargain as he possibly could.* In my opinion, the pipelines have negotiated, and will continue to negotiate, for the purchase of gas in every way which will result in the greatest benefit to themselves and their customers.

This experience of the industry cannot, as a matter of record, be disputed. Significantly, the Examiner, although not fully persuaded on this matter for the entire period of the 1950's, was able to conclude as follows:

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[4] Tr., pp. 28,138-139.

> . . . There is presently intense competition between pipelines for the limited growth in city-gate demand. And now that the city-gate price has advanced materially and distributors' costs have increased, competitive price pressures in the ultimates market have resulted in an added cost consciousness on the part of pipelines.

Since we are here fixing rates for the future, the circumstances with which we should be most concerned are reflected in the above conclusion.

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Reliance need not be placed solely on the above. It is more significant that the rise in the price of natural gas can be fully explained, and that this rise has been part of a long-term picture that cannot be overlooked if there is to be a dispassionate analysis of the price-rise argument. The Bureau of Mines has compiled data in its *Minerals Yearbook* into charts that begin with 1940 or 1945. Such data have been used to emphasize the price rise. This limited survey is misleading because it overlooks the experience of wellhead prices over a twenty-year period prior thereto:[5]

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[5] Record Exhibit No. 25, Schedule 2. See also Bureau of the Census, *Historical Statistics of the United States* (1960) and subsequent supplements.

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Year	Price (¢ per Mcf)	Year	Price (¢ per Mcf)	Year	Price (¢ per Mcf)
1922	11.1	1935	5.8	1948	6.5
1923	10.0	1936	5.5	1949	6.3
1924	9.3	1937	5.1	1950	6.5
1925	9.4	1938	4.9	1951	7.3
1926	9.5	1939	4.9	1952	7.8
1927	8.8	1940	4.5	1953	9.2
1928	8.9	1941	4.9	1954	10.1
1929	8.2	1942	5.1	1955	10.4
1930	7.6	1943	5.2	1956	10.8
1931	7.0	1944	5.1	1957	11.3
1932	6.4	1945	4.9	1958	11.9
1933	6.2	1946	5.3	1959	12.9
1934	6.0	1947	6.0	1960	14.0

This complete presentation reflects the full scope of the price history of natural gas production: a germinal period of relatively high prices followed by successively declining periods which resulted in depressed prices that were extremely low; the low point was reached during wartime when price controls were imposed based on market conditions; and finally, there was a period of successive increases during the post-war period responsive to the increased demand. Significantly, these statistics establish that the moving average price in 1954, when federal producer regulation was imposed, was 1.0¢ lower than that of 1922, and

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the oft-emphasized increase from 1950 to 1960 was but 0.9¢ greater than the seldom emphasized decrease from 1922-1940.

Even the increase from 1945-1960 must be placed in further perspective. Based on *Minerals Yearbook* statistics, the record exhibits reveal the explosive volumetric growth experienced by natural gas sales over the relevant period: in 1935, 1.92 trillion cubic feet; in 1940, 2.66 trillion cubic feet; in 1945, 3.92 trillion cubic feet; in 1950, 6.28 trillion cubic feet; in 1955, 9.41 trillion cubic feet; and, in 1963, 13.88 trillion cubic feet. During this period demand increased over 700 per cent. This growth, when considered with the circumstances that production rates of return on average total capitalization have declined steadily since 1951,[6] and that several large supply areas have developed from what were once considered doubtful prospects, conclusively establish that there is no substance to the proposition that extravagant producer returns resulted in unnecessary exploratory drilling activity during the relevant period. The activity of natural gas production is simply not susceptible to the same precision of cost-control that is possible in most manufacturing and retail operations. Ultimately, unproductive outlays will always be the price of flowing gas, just as flowing gas will always be the product of once doubtful expenditures.

Reflecting a remarkable demand explosion, the high desirability of natural gas as an energy source doubled its relative position in the energy fuels market. Gas supplied but 14.1 per cent of this market in 1946. This increased to 17.6 per cent in 1949, to 20.5 per cent in 1951, to 24.5 per cent in 1954, to 27.6 per cent in

[6] Respondent's Exhibit No. 220, Schedule 11.

1958, and to 29.4 per cent in 1960. While the 1946-1960 rate of growth for coal-lignite and liquid petroleum was a sluggish 2.4 and 4.7 per cent, respectively, natural gas experienced the rapid growth rate of 8.4 per cent.

The effect of this increasing demand on wellhead prices has been thus explained:[7]

> The sharp increase in field prices over the space of a year or so is undoubtedly responsible for much of the political support of price regulation for the industry. Such a rapid rise in prices is, of course, quite possibly compatible with the operation of a competitive market where consumption increases rapidly and where a part of the increase is in higher value uses, as has been shown to be the case in this industry. Total marketed production

> averaged 5.1 trillion cubic feet per year for the country as a whole in the period 1946-1950, compared with 8.8 trillion from 1953-1955, an increase of about 75 per cent, compared with the 86 and 93 per cent increases in price in [Texas Railroad District Number 4 and South Louisiana]. The relative price increases are not appreciably greater than the relative increase in consumption for the nation as a whole; and in these two areas marketed production was probably up more than the national total.

The increasing demand for interstate gas dictated that annual additions not only equal production, but that a reserve cushion also be added as a safety margin. As annual consumption increased, annual findings had to increase at a greater rate. Prices had to rise, not only to

[7] Cookenboo, *op. cit.*, p. 39.

meet rising costs, but also to finance the annual increase in capacity. In other words, prices had to more than recompense the previous investment in order to provide more than current production. The result was the classic reaction of a free market: prices rose, not only to increase capacity in response to demand, but also to limit that demand until deliverability had accelerated.

The price rise has had, and continues to have, two other highly desirable effects upon the disposition of natural gas: it curbed waste, and it deflected gas away from such inferior uses as carbon black production. The record portrays this quite distinct inverse relationship between price and waste:

Year	Average Wellhead Price Seven Southwestern States (¢ per Mcf) Constant (1947-1949) Purchasing Power	Wasted and Vented Seven Southwestern States Per Cent of Net Production
1946	4.1	24.7
1947	3.9	22.7
1948	4.3	15.7
1949	4.5	15.1
1950	4.7	12.2
1951	4.8	10.2
1952	5.6	10.0
1953	6.7	9.1
1954	7.4	7.7
1955	7.6	7.5
1956	7.7	7.6
1957	8.0	6.8
1958	8.7	5.1
1959	9.4	4.4
1960	10.1	4.2

The Bureau of Mines *Minerals Yearbooks* reveal the identical inverse relationship between price and less desirable uses:

Consumption Sources	1940	1945	1950	1955	1963
Residential	16.7	15.6	19.9	23.4	24.5
Commercial	5.1	5.9	6.4	6.4	8.7
Total	21.8	21.5	26.3	30.3	33.2
Oil Field	26.8	23.5	19.7	16.7	14.2
Carbon Black	13.9	11.0	6.8	2.7	.8
Refineries	4.8	8.7	7.6	6.9	5.4
Electric Utilities	6.9	8.4	10.4	12.7	14.6
Other Industrial	25.8	26.9	29.2	30.7	31.8
Total Industrial	78.2	78.5	73.7	69.6	66.8

In evaluating the advisability of placing primary reliance on field-negotiated prices, it is necessary to appreciate that the increase in wellhead prices was but a slight portion of the increase in burner tip prices, and that neither increase was inconsistent with contemporaneous trends. Witness Jordan's exhibit reflects the following relationship between wellhead and burner tip price increases:[8]

Year	Wellhead Prices	Average Value Residential Use	Wellhead Price as a Percent of Residential Value
1950	6.5	69.0	9.4
1951	7.3	76.0	9.6
1952	7.8	83.1	9.4
1953	9.2	86.5	10.6
1954	10.1	89.3	11.3
1955	10.4	88.7	11.7
1956	10.8	91.3	11.8

[8] Respondent's Exhibit No. 42.

Year	Wellhead Prices	Average Value Residential Use	Wellhead Price as a Percent of Residential Value
1957	11.3	93.0	12.2
1958	11.9	98.2	12.1
1959	12.9	101.1	12.8
1960	14.0	103.4	13.5
Increase			
1950-1955	3.9	19.7	19.8
1955-1960	3.6	14.7	24.5
1950-1960	7.5	34.4	21.8

The above clearly establishes that, while the years 1950-1955 saw a 3.9 cent increase in wellhead prices, they also saw a 19.7 cent increase in residential prices. The years 1955-1960 show a similar relationship: a 3.6 cent increase in wellhead prices and a 14.7 cent increase in residential prices. For the entire period, the relationship was 7.5 cents to 34.4 cents, revealing that residential price increases were the result not of wellhead price increases, but, among other things, of increases in the capital costs and expenses of transportation and distribution. The following nationwide figures are important:[9]

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DISPOSITION OF CONSUMER PRICES

Average Overall Prices	1954	1957	1960
	Prices (per Mcf)		
Wellhead Value	.10	.11	.14
Value at Point of Consumption	.38	.43	.50

[9] Respondent's Exhibit No. 32, Table 14.

	1954	1957	1960	
Functional Shares (per Mcf)				
Production	.10	.11	.14	28%
Other	.38	.32	.36	72%
	.38	.43	.50	100%

CHANGES IN CONSUMER PRICES

	1954 to 1957	1954 to 1960
Functional shares (per Mcf)		
Production	+0.01	+0.04
Other	+0.04	+0.08
Total	+0.05	+0.12

These charts are persuasive indicators that producers have not been the cause of "anarchic inflation". To the contrary, the legitimate costs of producing and delivering natural gas have necessarily resulted in price increases which must be borne to the end that a sufficient and assured quantity of gas is available for ultimate users throughout the Nation. Significantly, our opinion today establishes that costs have risen to rates that are no more than is required to provide natural gas service.

The price indices at production and consumption points for various fuels, and a comparison of production point fuel price increases to general indices is conclusive in the cumulative statistical presentation. The record reveals the following:[10]

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[10] Respondent's Exhibit No. 25, Schedule 15.

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Comparative Weighted Average Prices of Mineral Fuels at Points of Production in Cents per million BTU United States

Year	Natural Gas	Crude Oil	Bituminous Coal	Penn. Anth.
1945	4.6	21.0	11.7	23.2
1946	4.9	24.3	13.1	26.9
1947	5.6	33.2	15.9	28.4
1948	6.0	44.8	19.0	31.2
1949	5.9	43.8	18.6	33.0
1950	6.0	43.4	18.5	35.0
1951	6.8	43.6	18.8	37.4
1952	7.2	43.6	18.7	36.9
1953	8.6	46.3	18.8	38.1
1954	9.4	47.9	18.4	33.5
1955	9.7	47.7	17.2	30.9
1956	10.0	48.1	18.4	32.2
1957	10.5	48.2	19.4	35.4
1958	11.1	52.0	18.5	35.0
1959	12.0	52.0	18.2	32.9
1960	13.0	49.7	18.1	Not available

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Annual Indexes of Retail Fuel Prices
(1945 = 100)

Year	Oil Gas Residential Space Heating	No. 2 Fuel Oil	Bituminous Coal	Anthracite Coal
1945	100.0	100.0	100.0	100.0
1946	99.0	100.8	105.3	110.9
1947	100.0	120.2	124.4	120.4
1948	100.9	153.0	148.2	135.2
1949	102.2	145.0	153.6	144.4
1950	102.6	146.6	159.2	150.0
1951	103.6	155.0	162.8	164.5
1952	106.9	158.6	165.9	167.1
1953	112.6	166.8	169.3	178.7
1954	115.8	167.9	169.2	172.0
1955	121.8	173.5	171.0	168.9
1956	122.7	182.0	177.3	177.7
1957	124.0	191.4	184.4	193.1
1958	131.2	180.3	187.1	191.5
1959	135.7	182.8	190.3	189.6
1960	147.2	179.6	191.9	185.3

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These data reflect what has been too-lightly disregarded: that the rise in natural gas prices was not excessive in relation to the rise in interstate demand, the rise in wholesale price trends, the rise in price trends for competitive fuels, or the rise in average hourly earnings. They also reveal that criticism cast on the producer for residential price increases was 80 per cent misplaced, and accusations of extraordinary production returns were statistically unsupported. This overall picture is made clear by the chart on page 24. Rather than constituting a justification for rigid cost-plus regulation, the criticism is refuted by the extensive investigation and cross-examina-

tion that has occurred in this case. It must be concluded that natural gas has been earning no more than a fair return on its costs, and the absence of conclusive evidence to the contrary bolsters the presumption that the competitive factor in the field provides, within limitations, the necessary independent determinant to this Commission's regulatory responsibilities.

The absence of producer price-dictation in the Permian Basin

The early necessity for conservation laws in most states was a result of the ruinous competition that was possible in producing fields because of the law of capture. This era of active rivalry among producers is now past, but the opportunity for independent operation which led to state conservation regulation indicates the sense of independence that is common among the operators of producing properties. It is indeed fortunate that these early predatory practices have been eliminated. Furthermore, the prevention of drainage to protect correlative rights and the regulation of production to reflect market demand has not eliminated competition in other aspects of the companies' activities. The primary basis that leads to any presumption of a lack of competition has been the price rise. As discussed earlier, this has been no more than a reasonable rise responsive to high costs, and it was considerably less marked than the increases which resulted in other commodity-oriented industries.

Aside from the overwhelming concentration on costs by Staff and the California distributors, thorough con-

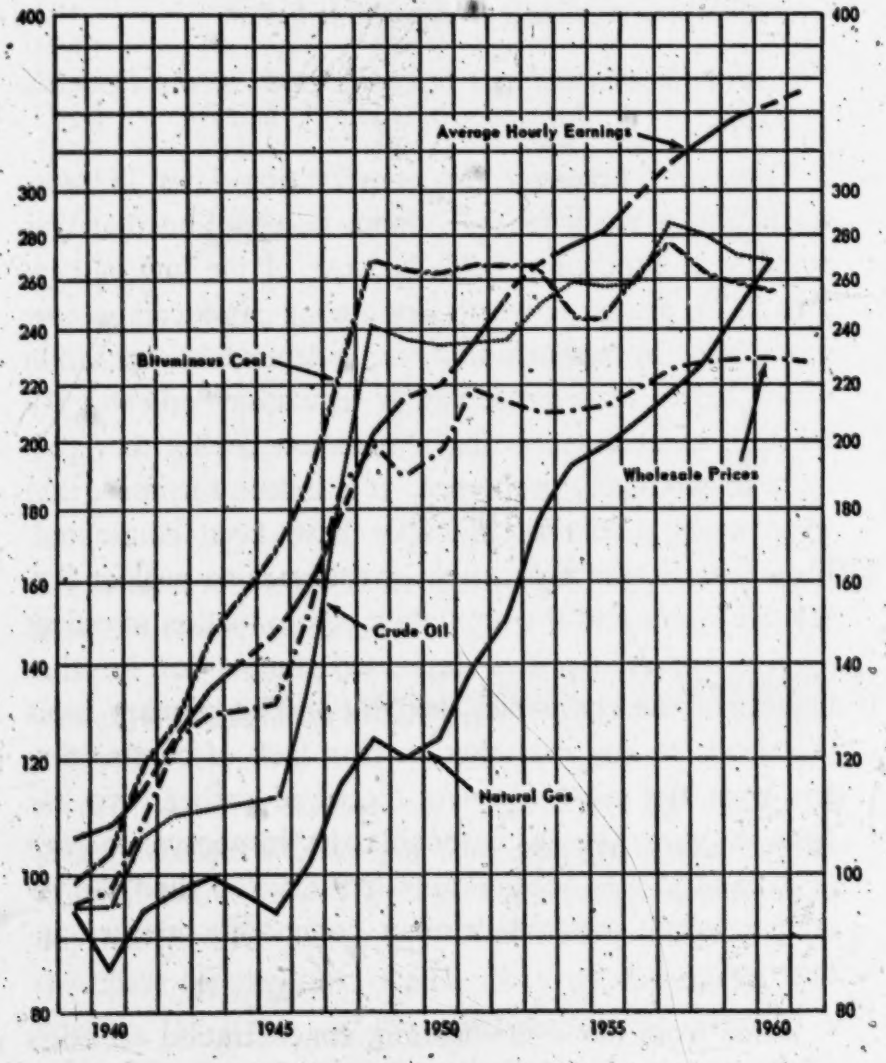
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COMPARATIVE TRENDS OF AVERAGE PRICES OF MINERAL FUELS AT POINTS OF PRODUCTION

United States

1939-1961

INDEX NUMBERS 1935-1939 = 100



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sideration of the competition issue has been clouded in a failure to make precise definitions. The problems of description and categorization result from the various meanings attached to the concept of competition. In my view competition means a buyer is free to purchase alternative sources of a product from relatively small sellers acting independently of each other.

However, in addition to the price rise emphasis, certain parties improperly assume monopolistic motivations. This assumption necessarily rests on the classical model of only two sellers of equal power; it thereby overlooks the environment in which enterprise operates: that of sellers of different size subject to a multitude of economic conditions, all of which combine to make any final price the subject of numerous considerations which regulators can at best estimate. More evidence is needed than a restricted competitive model. Consideration must be given to relative size, to numbers of companies, to ability to enter the market, to any business arrangements between various sellers and buyers, and to the countless other factors that make up a market. Of particular

significance to the producing industry are such special market conditions as acreage controls, flaring rules, and the prevention of lapse of the lease. The question is one of the power of a seller or group of sellers to dictate a price that is divorced from costs. This condition does not exist in the Permian Basin. It is clear that there is such a measure of effective competition that in future proceedings producers can be accorded a relative degree of independence to the end that contract prices determine the ceiling price we set for natural gas.

On the record before us, there is no evidence of monopolistic power possessed by producers in the Permian Basin. The issue, though properly raised by the producers, has gone unnoticed by the other parties. Respondents have met the burden of proof on the competition issue. Staff and the California intervenors have not. The state of the record is such that Respondents have made every possible showing of competition, and, further, they have shown that this competition is sufficient, under a majority of the contracts, to provide a meaningful methodology for determination of just and reasonable rates. It is no answer to say that the producing industry has not met its burden. The burden of proof is not solely on Respondents. Although this proceeding involves Section 4(e), filings, where the burden is expressly placed on producers, it is essentially a Section 5(a) proceeding in which our Staff must make the proper showing. Nevertheless, this case cannot turn on the burden of proof. There is sufficient evidence on all issues.

Furthermore, that this is a regulatory proceeding does not detract from thorough consideration of relevant economic evidence to ascertain whether producers exercise undue powers over price. Certainly there is no basis for a presumption that there is no competition. The ramifications of the order we issue today require comprehensive and meaningful treatment of this issue.

Briefly, the record shows that, of all producers in the Permian, 361 were named in the order initiating this proceeding, but no one of these sells over eight per cent of the gas produced on a national basis. In addition, at least 2,280 producers in the Permian Basin supply gas to processing plants under percentage contracts. In the aggregate, there were 54 producers in 1960 who sold over ten million Mcf of gas per year. In the Permian Basin there are 20 producers selling some 80% of the gas produced. These numbers and sizes necessarily raise the presumption that there is such a degree of self-interested rivalry and of independent action as to preclude a presumption of concerted action. On the other hand, there is not a scintilla of evidence that any of the producers have ever acted collusively; they have not exercised their power in a manner harmful to the competitive market. There has been no parallelism in prices to indicate action by any producers to

control price. This stands out clearly:[11]

Year	Company	Number of Contracts	Price Range
1953	El Paso Natural Gas	45	9.0¢-10.0¢
1954	El Paso Natural Gas	80	8.5¢-10.0¢
	Permian Basin Pipeline (Northern Natural Gas)	6	9.0¢-10.5¢
1955	El Paso Natural Gas	32	8.5¢-10.0¢
	Northern Natural Gas	2	9.5¢-15.0¢
1956	El Paso Natural Gas	47	7.5¢-10.0¢
	Pioneer Gathering System	1	11.0¢
1957	El Paso Natural Gas	36	9.5¢-11.0¢
	Northern Natural Gas	7	9.5¢-16.0¢
	West Texas Gathering Co.	15	16.0¢
1958	El Paso Natural Gas	34	10.5¢-11.0¢
	Northern Natural Gas	1	9.5¢
	Transwestern	10	16.0¢-22.0¢
	Pioneer Gathering System	9	10.0¢-12.5¢
	West Texas Gathering Co.	2	16.0¢
1959	El Paso Natural Gas Co.	24	9.0¢-11.0¢
		407	14.5¢-17.0¢ (renegotiated)
	Northern Natural Gas Co.	3	13.5¢
	Transwestern	12	16.0¢-22.0¢
	Pioneer Gathering	2	12.5¢
	West Texas Gathering	5	16.0¢
1960	El Paso Natural Gas	19	10.5¢-17.0¢
		15	15.0¢-17.0¢ (renegotiated)
	Northern Natural Gas	1	13.5¢
	Transwestern	23	15.5¢-22.0¢
	West Texas Gathering	5	16.0¢

[11] Respondent's Exhibit No. 25, Schedules 12 and 13.

Such a vast range in prices over the period of almost a decade certainly is suggestive of the fact that all producers, or even the major sellers do not exercise effective monopoly powers.

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There is relative ease of entry into the business. Such discrimination as may exist comes, not from producers, but pipelines. Further, it must be emphasized that such factors as a rapid growth rate, excess capacity, and meeting the prices of a rival are conditions to be expected in a market that is rapidly expanding and coming into its own. The opening of markets and the high rate of technical progress usually characteristic of such a situation make for uncertainty as to the most profitable policies. Any uncertainty of prices under contracts, even when Transwestern broke El Paso's monopoly, reflects no more than unprecedented demand and not monopoly control by producers.

The sole non-competitive factor has been the long-term contract, required by this Commission as a condition precedent to certification. Early uncertainty as to the proper prices for natural gas and particularly its use as a waste product acerbated this twenty-year pricing policy by compelling producers to insist on various indefinite escalation clauses to the end that, once stable prices were realized at a level that returned costs to the producer, each seller would so benefit. These clauses have been negotiated in the Permian since at least 1945 when El Paso contracted with Phillips for a sale of gas

at 3.5¢ per Mcf, but subject to indefinite escalation based upon El Paso's resale rates at the California border. Since the middle of the last decade, such indefinite escalations have been uniformly condemned. The following comment is relevant:[12]

> Many witnesses appearing before the committee, particularly those representing distributing interests and consumer areas, maintained that escalation clauses in existing contracts, unless their operation is controlled in some effective manner, could result in very large increases in the cost of gas to consumers —
>
> 277,733
>
> particularly in view of the fact that a contract for natural gas usually runs for 20 years or more, and a large proportion of the contracts presently in effect were entered into in recent years . . .
>
> It is provided . . . that where a rate increase is based on a price increase resulting from the operation of an escalation clause [except the so-called step-up and tax-increase clauses] in an existing contract the Commission may not consider as an operating expense for the purchase of such natural gas any part of the increase in price which results in a price in excess of the reasonable market price therefore.

We have endorsed the above recommendation by prohibiting the prospective operation of such clauses.[13] Our

[12] Report of the Committee on Interstate and Foreign Commerce; to amend the Natural Gas Act, as amended; House Report 992, p. 9 (84th Congress, 1st Session, 1955).

[13] See the *Pure Oil Company*, 25 FPC 383 (1961); Order Nos. 232 and 232-A, 25 FPC 379, 609 (1961), amending Sections 154.91(a) and 154.93 of the Commission's Regulations under the Natural Gas Act.

opinion today permits their further operation only to the extent they were negotiated in past periods and in any event such escalations cannot exceed the ceiling rates. Looking to the future the extensive impact of limited price increases in new contracts cannot approach the increases realized in the last decade. Thus, by this determination, there is a solution to the single factor that has compromised workable competition.

Finally, in determining the competition issue, it is relevant to consider an energy market broader than the natural gas industry of the Permian Basin. It is clear that natural gas is presently sold at a level competitive with other fuels and sources of energy. This is particularly the case on a national basis, and is the result of continuing economies in the coal and electric industries. If our analysis is expanded beyond the Permian to take cognizance of this national energy market, there is evidence of those conditions that would indicate restrictive economic forces. There are alternative energy sources to provide an independent

determinative of prices. The consumer's individual outlay does not restrict his freedom to select alternative sources; the energy market is in a state of equilibrium. For this reason, if no other, transmission companies cannot disregard the prices paid to producers, and, particularly for the future, it cannot be assumed that the pipelines do not have the same interest in their investment as the distributors have in their related investment.

Reliance on the price rise to justify a conclusion of producer price-dictation must falter in the face of overwhelming evidence that this rise was parallel to the rise in all other price indices, that the price rise reflected the elevation in the value of natural gas to a level that would return to the producer his reasonable costs, and that there is competition sufficient for our regulatory purposes. For these reasons, I rely upon the reasonable market prices in addition to the cost considerations in our decision.

JUST AND REASONABLE RATES BASED ON CONTRACTS

Far from undercutting our power to impose effective price ceilings, a price-demand approach would retain flexibility and would still present a direct relationship between cost considerations and the price ceiling. In view of the cost presentation herein, it appears that in the future reliance on competitive forces should be sufficient. The independent operation of substantial parts of the market will provide an average price accommodating to the mandate that controls be imposed upon prices for natural gas. To the extent possible, one part of an essentially joint product will be regulated in a manner responsive to the needs of both the industry and the consumer. So long as most producers can operate under a compulsory price ceiling, the supplies will be available, and by that ceiling the consumer will be protected from price escalations that are not acceptable. The question becomes one of methodology. Although it might be preferable to enact legislation to abandon any effort at

price control other than such reasonable restraints as might be imposed upon pipelines, such limited controls are not totally removed from a method that has proven successful in the last few years.

Relevance of our in-line pricing policies

Following the Supreme Court's mandate in *Atlantic Refining Company* v. *F.P.C.* (*CATCO*), 360 U.S. 378 (1959), the Commission has followed a course in Section 7 proceedings of fixing ceilings at reasonable rates relevant to the existing market. It has thereby centered its attention on the weighted average prices under contracts which provide for the sale of substantial volumes of natural gas in interstate commerce. Indefinite escalation provisions have been removed, and rate increase moratoria have been imposed. Attention has been directed to permanent and temporary certificates covering contract rates, and the Commission has strenuously resisted all attempts to interject cost presentations submitted on an individual company basis. It has thus been successful

in effectuating, simply, quickly, and with minimal disruption, what five years of agitation and uncertainty, fraught with numerous procedural disruptions, can scarcely improve upon: fixed rates that are sufficiently high to induce adequate reserve accretions and yet with provisions for rate increases that would be so gradual that any unpredictable economic disruption at the distribution end of the natural gas industry would be precluded. Al-

though the procedure was notably unrefined, it has likewise proven to be remarkably efficacious. The in-line procedure took the notable step of avoiding cost-plus producer regulation and thereby illustrated that a "sane, sensical, and effective" course to producer regulation was available. Significantly, it represented initial development of the policies we adopt today. Nevertheless, since in-line proceedings arise under Section 7, it is appropriate that there be a more thorough analysis of contract prices when consideration is given the standards of Sections 5(a) and 4(e). Thus, the Ninth Circuit has stated that the provisions of Section 7 for certificates of public convenience and necessity do "not mean that before certificating such a sale the Commission must determine that the proposed initial price is just and reasonable [by Section 5(a) and 4(e)]." *United Gas Improvement Co.* v. *F.P.C.*, 283 F.2d 817, 822 (9th Cir. 1961).

The record in this case provides substantial evidence that in the future we should perfect a system of producer regulation that considers costs, but relies on the competitive forces, which in themselves provide an independent determinant to prices apart from what producers might prefer to dictate. Thus, the logical focus of producer regulation on an area basis lies in the negotiated field contracts. They are executed under circumstances of market compulsion after full consideration by persons intimately associated with the industry of all the factors that a regulatory agency can only estimate. These contract prices provide a privately-litigated answer to the question of what rates will be necessary to get the gas out of the ground. Any meaningfull system of regula-

tion would appraise the level of these prices as determined by arm's length bargaining in a competitive market. The analysis should include intrastate prices for that market will provide useful information for comparative purposes. While it is to be expected that regulation will distort a competitive market, contracts continue to be negotiated above these ceilings, and in-line price conditions are refused by producers in favor of other markets. Finally, since costs now approximate revenues, it should follow that competitive prices would accordingly be in-line.

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The focus on contracts would remain constant unless there were important departures in direct relation to current experiences and projections of production volumes, exploration and development expenditures, drilling success ratios, market demand reserve additions, and the general cost indicia of the national economy. Of these several economic indicia, the single most important one is the reserves added each year. This is the crucial measure of the ability of just and reasonable rates to elicit the necessary supply. For present purposes it is apparent that field negotiations have been successful in eliciting supply, and that no specific reserves to production ratio should be required. The other important economic indicia are exploration and development expenditures and drilling success ratios. Both are joint costs of the oil and gas industry, but substantial deviations of either over the long term will require corresponding rate adjustments. Necessarily, both relate to the supply

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elicited. It is these relationships that can best assist us in a determination of whether regulatory controls are successful in meeting current and projected needs. If adequate reserves were being elicited, an uncomplicated, practical decision would be one which imposed a single ceiling approximating the initial price mode or median of new contracts. If additions were excessive, based on current ratios, the ceiling could be lowered to inhibit exploration and dedication of further volumes to interstate commerce. If additions were deficient, the single ceiling would be adjusted proportionately upward, and, if the reserve posture required even more drastic remedies, contract rates could be increased upward pursuant to Section 5(a) as construed in *F.P.C.* v. *Sierra Pacific Power Co.*, 350 U.S. 348 (1956). Finally, if specific rates were unduly discriminatory or preferential in specific cases they could be adjusted within the purport of just and reasonable rates.

Such a policy could be implemented with a maximum of time and expense. The regulatory burden would be greatly relieved, and Federal expenses would concomitantly be reduced. Although an orderly conclusion of pending area rate cases is presently required, contracts should provide an expeditious basis for setting just and reasonable rates in all other producing areas. Ancillary benefits would follow as cost-plus thinking is de-emphasized. More meaningful reserve data would be obtained. Difficult allocations could be of more limited impact. Cost questionnaires, indicative of whether trends in wellhead prices were approximating general indices,

would be far more simple and consequently far less expensive to complete. Since prices would be established expeditiously, they would be maintained current without resort to figures and testimony that are five years old. This would be achieved in addition to our current policy, clearly the most consumer-conscious yet effected, of imposing increased limitations to maintain current prices with provisions for filing for moderate increases in accordance with market determinations and other general economic trends.

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The Reasonable Market Prices:

Subject to these additional views on the course we should take in establishing just and reasonable area rates for the Permian Basin, I concur fully in the Commission's opinion. Our opinion establishes that profit-oriented costs and supply oriented contracts do not, in the aggregate, depart in any significant manner from each other. To the contrary, an analysis of market prices establishes that contracts have apparently approached costs for the natural gas industry in the Permian, and, for the past few years, have maintained a level close to the cost analysis we here adopt. This is a significant stabilization. Thereby, a market price has been established which provides a reasonable measure of the rate necessary to elicit supply. From the record in this proceeding, for the period with which we are concerned, the overwhelming volumes of gas-well gas are sold under new contracts at the weighted average price of approximately 16.5¢. Con-

sidering this close proximity of the contract average to composite costs, it is clear that, by either standard, the rates we prescribe for the Permian Basin are just and reasonable.

The record establishes that, for all filed contracts in a seven-year period before and after 1960, there was a range in prices from 2.15 to 18.0¢.[14] The weighted average price for these contracts, based on volume, was 14.20¢ for 1962. This price is based on the initial contract price, and it is not shown what adjustments, if any, were provided for quality, taxes, and other circumstances. These have a definite impact on the regulatory rate we must establish. More particularly, as of early 1962, approximately one-half of the volumes sold was at an upward range from 15.0¢ to 17.0¢. Under various periodic escalations this price could be increased, by the end of 1968, to a price ranging from 16.0¢ to 18.0¢, with the overwhelming volumes being sold at prices approaching 18.0¢. Since we here intend price control up to an earlier date, Respondent's contract testimony is commensurate with the just and reasonable rate for the period. Other testimony establishes that, for contracts dated subsequent to 1960 but prior to the middle of 1963, the base prices range from 9.0¢ to 17.0¢ for gas-well gas, with the larger volumes flowing at rates ranging from 15.5¢ to 17.0¢ with the largest volumes at 16.0¢.[15] Based upon this survey of base prices under contracts, some as reduced under certificate conditions and accepted

[14] Respondent's Exhibit No. 252.

[15] Staff's Exhibit No. 317A.

by producers, the 16.5¢ rate established by our cost analysis is clearly within the range of contract prices.

There are limitations in relying solely on the above evidence, primarily because various adjustments for deviations from the standards for pipeline gas are not necessarily reflected in the contract price for new gas-well gas. The weighted average contract price for gas-well gas is 14.76¢, apparently after certain proportionate adjustments to reflect deficiencies.[16] Among others, these deficiencies include excessive sulphur and hydrogen sulfide content, excessive water content, below

standard pressure, and excessive carbon dioxide in the gas. From the record it appears that the possible range for specific adjustments will be from three to five cents; however, for all adjustments that might be necessary, the reasonable amount of the average adjustment will be in a range of from 1.0¢ to 1.7¢.[17] Adding this adjustment to the average weighted price of 14.76¢ a ceiling is indicated of from 16.0¢ to just below 16.5¢. In accordance with a policy of rounding upward, this would mean that a price of 16.5¢ is the just and reasonable rate for new gas well gas.

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[16] Staff's Exhibit No. 334.

[17] A precise adjustment for quality cannot be ascertained from the contract exhibits in this proceeding. The Examiner made a general determination that one cent would be appropriate. See Examiner's Decision, pp. 69-73. Subject to developments under the quality adjustment procedures, we establish, the range is presently appropriate.

Further analysis of the record evidence supports the above conclusion.[18] Since the contract prices must be considered in the light of the quality of gas sold, it appears clear that, of the limited volumes of gas sold at pipeline quality standards, the 16.5¢ rate is clearly in line. The highest price for new gas-well gas is 17.0¢, which was paid for an estimated annual volume of 2,126,400 Mcf under six rate schedules. All of this gas appears to meet pipeline quality standards, except for 180,000 Mcf of gas sold under one contract allowing a lower Btu content and containing no specification as to water content. A larger quantity of new gas-well gas was sold at 16.0¢ — 6,149,336 Mcf to El Paso, 9,751,680 Mcf to Transwestern, 2,444,772 Mcf to Northern, and 958,320 Mcf to West Texas Gathering Company. All contracts for sales to West Texas Gathering Company would allow delivery of "sour" gas. The 16.0¢ price might have been higher had the gas been required to be of pipeline quality. These contracts are silent with respect to water content. Contracts governing the 2,444,772 Mcf sold to Northern provided for a minimum Btu content ranging between 950 and 1,000 and had no provision with respect to water content. These contract provisions do not reveal the actual quality of gas delivered, but again it appears that the 16.0¢ price would probably have been higher for higher quality gas. It is indicated that a 16.0¢ price paid by Transwestern was negotiated despite variations in the quality of the gas. Some 420,000 Mcf sold under three contracts is subject

[18] Staff's Exhibit No. 334.

to contract provisions requiring that the gas meet all pipeline quality standards save that the contract is silent with respect to water. The actual water content of the gas delivered cannot be determined. The remainder of the gas appears to be below standard in either pressure or in hydrogen sulphide content. Some 1,108,000 Mcf of this gas may also be deficient in Btu content, and about 6,475,000 Mcf of this gas moves under contracts which provide no standard with respect to water. The El Paso contracts at 16.0¢ are uniform in fixing delivery pressure at 1,000 pounds but are silent on most of the other quality standards.

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At the contract price of 15.0¢, estimated annual volumes of 8,433,048 Mcf of new gas-well gas were sold to El Paso and 2,007,324 Mcf to Northern. The 26 El Paso contracts at this level are, with two exceptions, silent as to water content. Eleven of them require pipeline standards with respect to sulphur and hydrogen sulphide. One is silent on this subject, and the remaining 14, totaling nearly 3.5 million Mcf, do not require pipeline standards with respect to sulphur. Pressure appears to be below pipeline standards in the case of the majority of the 15.0¢ gas sold to El Paso, and possible Btu content deficiencies are indicated with respect to about one-third of this gas. The three contracts at 15.0¢ for sale of new gas-well gas to Northern provide for pipeline quality standards in all respects save that no standard was provided with respect to water content. Again we have no

information as to the actual water content of the gas delivered. From the above it must be concluded that new gas-well gas delivered at prices below 15.0¢ is, from the record before us, deficient with respect to one or more quality standards.

Attention should be called to the fact that the prices set forth in this exhibit are not for all the market sales of gas in the Permian Basin Area. No information was included in this record as to particular non-jurisdictional sales although some attempt was made by the Staff to show that the average non-jurisdictional prices were lower than jurisdictional prices. I emphasize that such intrastate conditions of the market are relevant considerations to area pricing. Taking all these factors into consideration upon the evidence presented, it must be concluded that our price of 16.5¢ set for new gas-well gas is appropriate; therefore, a just and reasonable rate is established.

Despite the validity of the 15.5¢ base price (exclusive of State taxes) for new gas-well gas, it is not acceptable to the extent that there is not a full upward adjustment for high Btu content.

It is clear that the quality of a particular volume of natural gas has a definite impact on the value we should assign to that gas. Consumers are interested, not in Mcf's, but in the heating units derived therefrom. For variations from what is required to supply consumers adequate therms of gas, there should be proportionate adjustments. On the basis of the record before us it is a matter that is not readily susceptible to resolution, and,

to determine the full extent of the adjustments that might be necessary, we have ordered procedures for negotiation of these matters.

It appears that natural gas from the Permian Basin is generally deficient in many of the standards required for pipeline quality as we have proposed in R-200, noticed at 18 FR 2.60, 2.61 (1961). A large amount of sour gas is found, there are several fields with large amounts of carbon dioxide, and low pressures are common. These deficiencies are to be reflected in downward adjustments from our base prices. On the other hand,

Permian gas does have one quality — Btu content — that is apparently higher than is delivered to pipelines in other producing areas. I dissent from the anomalous position of requiring full downward adjustments for all quality deficiencies while denying to producers a right to obtain meaningful upward adjustment for the single quality standard that is above pipeline quality. I emphasize that this dual standard attacks the validity of our cost analysis since, absent proper upward adjustments, it is possible that producers will not recover their legitimate costs.

In our recent decision in *Texaco Inc.*, Opinion No. 464 (issued June 10, 1965), we determined that, for the Hugoton-Anadarko producing areas, 1000 Btu's was the standard for pipeline quality there. Significantly, we relied on the contract terms, although Staff had favored

a weighted average base of approximately 1020 Btu's. It is appropriate to adopt area standards, but this being an area proceeding, all relevant circumstances should be considered. It is far from clear that the area standard for new gas-well gas is at 1050 Btu's. The weighted average for new gas-well gas is 1042, but this average is derived by excluding carbon dioxide volumes; if the latter are included the weighted average is lowered to 1034 or lower. Furthermore, it should be noted that the weighted average for all gas flowing in 1960 appears to be at 1039 Btu's. If our attention is directed to the contract requirements of the pipelines, which is the standard for determining all the quality deficiencies, it is clear that the minimum required is 1000 Btu's or lower. The standard Btu provision imposed by the transmission companies for purposes of price adjustments or rejection is between 1000 and 950 Btu's, but the preponderance of the contracts requires 1000. The opinion is thereby left with an obvious gap of 50 Btu's by which producers are denied the benefits of the gas they sell. If we compare the area standard with the national standard, it is clearly at 1000 Btu's, as we have proposed in R-200. Finally, it appears that the 50 Btu gap is important solely to the California distributors as a result of the high Btu content in the gas delivered to them at the California border. The reasons for this high standard are not known; certainly no producer participated in the negotiations leading to these sales. Rather than approve a practice of unknown origin, I would rely on the uniform contract standard for the Permian area, for the Nation, and for our proposed R-200

to set an upward adjustment from 1000 Btu's for new gas-well gas.

There are major difficulties in basing regulation on contracts while adopting the directionality thesis. Under price-demand split-level pricing should be avoided. In addition, since the natural gas industry generates a large portion of its own capital, it thereby underwrites current exploration by the older production. Reinvestment is an accepted and necessary feature of the industry, and the revenues it receives must be a source of funds for continued and increased nationwide exploration and development. We can be assured that the needed gas will not be found unless we acknowledge a proper role to reinvestment. This conclusion is particularly compelling during a transition to effective just and reasonable rates. We must condition our determination today to developments under a two-price system. Directionality is presently acceptable as an exploratory device of the industry. Because of the variance in elasticity between casinghead gas and gas-well gas, price can be utilized as a device to elicit supply; however, such regulation must be premised on a two-price system to reflect

market conditions. In these circumstances, the selection of a dividing line between old and new production can be made. In view of the necessary role of reinvestment and of the long pendency of these proceedings, the division date should be drawn between the years when reinvestment was the sole reliance and when directionality had

begun to establish itself. Since this had occurred by 1960, I accordingly join in the division date for old and new gas. For the test year, the weighted average price for all flowing gas-well gas was below 14.5¢. Again, the record is deficient as to the quality of this gas. The record does establish that the weighted average revenues received for all gas-well gas flowing in 1960 was 13.05¢.[19] Applying an appropriate upward adjustment for quality deficiencies a price in the range of 14.0¢ to 14.5¢ is established. It is noted that this is a different standard for determining a price for old gas-well gas than for new. Nevertheless, it is an appropriate standard for determining a regulatory rate reflecting the price at which a majority of producers are able and willing to sell gas for a period encompassing several years during which costs were apparently being recovered. This is offset by the less demanding standard required for new gas-well gas to the end that an appropriate incentive is utilized. Further, the 14.5¢ ceiling applies to new casinghead gas and to residue gas from non-gas-well gas reservoirs. This reflects the relative inelasticity of those types of gas. Therefore, it can be concluded on the present record that the cost-plus rate of 14.5¢ for flowing gas is the just and reasonable rate, and I accordingly support the rate design prescribed. For future proceedings our opinion should lend support to this simpler and more realistic approach.

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[19] Staff Exhibit No. 175, Schedule No. 1. It should be noted that the average initial price for gas-well gas sold in 1960 is 13.2¢. See Staff Exhibit No. 118.

It follows from my dissent as to the appropriate Btu standard that I also dissent from the determination to permit an upward Btu adjustment only for new gas-well gas. The fact that tremendous volumes of high Btu content gas are sold in residue gas, in casinghead gas, and in old gas-well gas is not considered, although our quality standards otherwise apply to all types of gas. I cannot condone this discriminatory determination. Upward Btu adjustment from a base of 1000 should be applied to all gas from the Permian Basin. I would note that the additional revenues to the producers as a result of the 1050 standard will apparently be so minimal as to be meaningless. The better course would be to avoid any standard pending developments under the quality adjustment procedures.

Although I believe a more complete discussion of just and reasonable market prices should have been added to supplement the reliance solely on cost-plus, I support the rationale in the main opinion. The cost analysis there employed is not only reasonable; more important, it is a feasible synthesis of the cost evidence before us. Such costs are most useful as a basis for comparison to the contract prices. Our proceeding has established a significant point: there is no substantial difference between market and costs in the Permian. Either method is presently permissible

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for purposes of area ratemaking. Accordingly, with the single exception of the Btu standard, I join in the procedures recommended for applying and enforcing the prices determined here today.

/s/ L. J. O'CONNOR, JR.
L. J. O'CONNOR, JR., Commissioner

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Area Rate Proceeding Claude E. Aikman, *et al.* North Central Oil Corporation (Operator), *et al.*	*Docket Nos.* AR61-1 G-18466, *et al.* CI60-435, *et al.*

(Issued August 5, 1965)

ROSS, Commissioner, *concurring and dissenting on limited issue:*

The instant decision represents, in my opinion, a noteworthy advance toward the goal of effective producer regulation and one which, with but one exception, I fully support. In addition to the Examiner and the parties, we are indeed indebted to our Staff and our predecessors on the Commission for their ingenuity in suggesting the concept of the area approach and for beginning this case.

The decision properly recognizes that the basic purpose of the Commission's rate regulation is to assure for the consumers of this nation an adequate supply of gas at reasonable prices. In the course of developing a methodology to meet this objective the majority significantly expresses a flexible and receptive attitude towards

certain issues that were not adequately developed by the parties in this first attempt at area producer regulation, notably capitalization of E & D costs and the usefulness of econometric presentations. My principal purpose in writing this separate statement is to emphasize and focus attention on the changes forecast by the majority, and to suggest future potential refinements in both the methodology and basic data.

While the decision is essentially sound, there can be little dispute that the margin of error will be narrowed as more complete and meaningful data are made available. Surely regulators should not be expected to vouch for absolute accuracy of their predictions without comprehensive and comprehensible gas reserve information.

Since the advent of electronic computers, econometrics has become increasingly useful in many fields as a tool for analyzing complicated economic problems. For the first time in a proceeding before this Commission, an attempt was made to analyze and test the complex interaction of regulatory and market factors with the aid of such advanced statistical and mathematical techniques. The Staff's econometric studies, commonly referred to as the Weln model, were a commendable effort to clarify the supply-eliciting function of natural gas field prices. This is one of the strongly contested and critical issues in this proceeding. The producers, drawing mainly on an analogy with unregulated competitive markets, argued that higher gas prices will elicit larger supplies. The Staff, on the other hand, stressed the inherent limitation on the industry's ability to respond to change in gas prices.

According to the Staff's presentation, the economic determinants of future gas supply include not only the price of gas, which is being fixed in this proceeding, but also various other factors such as the determinants of market demand, the price of oil, and the success ratio in exploratory drilling.

One valuable feature of the Staff's studies is the attempt to identify and quantify both the direct incentive effect of price on exploratory activity and the indirect "feedback" effects on supply due to the price elasticity of gas demand under conditions of interfuel competition in the market place. These opposing effects, as well as the independent effect of oil prices on exploratory activity, cannot be assessed profitably in the abstract, i.e., by gut reaction, but should be quantified, if at all possible, in the interest of more informed regulation under the Natural Gas Act. An example of this questioning attitude is Staff's refusal to accept automatically the proposition that the supply-eliciting function of price in unregulated competitive markets, where price is the result of the push and pull of impersonal market forces, is duplicated in the gas producing industry.

In the long run, I am confident that such analyses will provide fresh insights into the behavior of natural gas supply. I am also confident that this modern economic tool, as it becomes better known, will be adopted by the industry for its own use. Inevitably, this will result in a better understanding of the industry both for the manager, the regulator and the consumer.

In view of the fact that directionality with a two price system has been accepted by the Commission, it is inappropriate for this reason alone to use the results of Staff's studies. Their usefulness in the context of this case has been to cause everyone to wonder about and question the heretofore unchallenged hypotheses of the petroleum industry. When better developed, I am sure the results will provide both a practical and *legal* foundation for better gas producer regulation. I am therefore looking forward to the continuing use and refinement of the application of econometric and other advanced analytical techniques to the difficult task of producer regulation in future proceedings. Surely we should strive for more objective evaluation of economic matters in contrast to relying on our "feel" in such situations.

In view of the basic approach adopted in the decision, the desirability of establishing future area rates in the context of a nation-wide proceeding — from both an economic and administrative standpoint — is strikingly confirmed. The price for new gas is based entirely on a nation-wide rationale and on nation-wide data. This same

basis is used to support the price determined for all other gas. As the decision concludes, the search for gas is conducted on a national basis. This is true not only with respect to producers but increasingly regarding the pipelines as well. The evaluation of location on price, the importance of which the decision affirms, can be determined much more effectively — if not exclusively — in

a proceeding which considers the interrelationships of the various areas of supply with the markets they serve.

From a purely administrative point of view, a nationwide proceeding is a practical necessity. This marks only the first area case, which covers three producing areas. At this time final decisions in the three pending area cases involving eight producing areas are far from imminent; yet a further consideration of Permian rates will be due in a relatively brief two and one-half years. At this rate of progress, a review of Southern Louisiana rates could be due even before the Hugoton-Anadarko cases are concluded. It is easy to see that the Commission could well become involved in the determination and redetermination of the rates for but a fraction of the producing areas in the country, and never complete the job of determining the rates for all of the producing areas. Either this will be the result, or the Commission as well as the industry and other interested parties will be required to add tremendously to their staffs.

Considering area rates within the framework of a national proceeding would also obviate the necessity of plowing the same old ground time and time and time again. Area proceedings involve substantial time and cost not only for the parties but also for the Commission and its staff. While separate area proceedings have advantages for the first couple of cases, the law of diminishing returns rapidly takes over.

Another aspect of our decision which is ripe for further consideration concerns a method of pricing new gas, com-

monly referred to as project accounting. This method visualizes a project consisting of the finding of a given volume of non-associated gas reserves by the drilling effort in a specific test year (e.g., 1960) and the subsequent production of that gas over an assumed depletion period. All necessary outlays to acquire the capital assets (i.e., the reserves), together with an appropriate return on the investment over its productive life, are assumed to be recovered through the revenues traceable to the initial investment. Cash production expenses related to the lifting of the gas to the wellhead are also estimated and added to the investment charges to arrive at a total cost per Mcf to be recouped on a unit-of-production basis over the depletion period. This cost model, which capitalizes all investment outlays relating to the acquisition of the asset and then

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allows a return thereon during its period of commitment, requires what is sometimes called a "true yield". The acceptable method of determining such a rate is an investor-demand type of study focusing on the "capital attraction" rate or the experienced cost of borrowing in the capital market. This is the rate of return standard that is commonly applied by the Commission in regulating natural gas pipelines and electric utilities.

This method can be compared with that employed by the Examiner and adopted by the Commission which is probably best characterized as a form of cross-section accounting. Under the latter method, the costs are esti-

mated for the volumes produced in a given year, assuming equal production from a universe of gas producing properties equally distributed by vintages (thus cross-cutting all vintage projects). Further, under a convention of accounting in the petroleum producing industry, but without logic in economic costing, the cost model of the distributors capitalizes only the costs directly associated with productive properties, which is only a portion of the total cash outlays made in acquisition of the reserves. Outlays for dry holes and other expenditures not directly associated with successful properties are presumed to be expensed in the year of outlay, rather than to be recovered in future years from the revenues of producing properties discovered in the course of a general exploratory effort. Thus, E & D expenses, not related to the production or output of the given year, are substituted for those E & D outlays of previous years which were incurred in connection with the successful exploratory efforts and recouped in the given year when the reserves are being produced. Cash production expense, depreciation, depletion, and amortization expenses, and a return on investment computed on a cross-section basis are also charged on a unit-of-production basis.

In selecting a cost model for new-gas well gas, consideration must be given to the fundamental character of the economic costing problem. Unit costs of production for any commodity or service can only be arrived at by a careful matching of all necessary inputs with the associated output. This matching must, because of the time value of money, adequately reflect the timing as well

as the cost of all inputs. Inputs allowed must strictly relate causally to the output and all such inputs, with their timing, must be fully represented. The project method of accounting meets this basic requirement. In contrast, the other method expenses the portion of the capital outlays which relates to unproductive properties as if they were current operating costs, even though that portion is inseparable, at the initial planning stage, from the successful E & D outlays. Such expensing practices can lead to a distortion of the investors' allowed return from revenues generated by the initial investment.

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In addition, an ancillary benefit of the project method lies in the fact that the somewhat discomforting aspect of "Adjustment for Exploration in Excess of Production", which seems to charge current rate payers for additions to a company's capital assets, is avoided.

This costing approach of capitalizing unsuccessful as well as successful well costs has substantial support within the accounting profession. Arthur Andersen & Co. has enunciated this position clearly and forcefully:

> "The purpose of exploratory activity is to discover oil and gas reserves for future use. Discoveries, however, are unlikely without the incurrence of some exploration costs for unsuccessful ventures. Such costs are necessary in the search for and discovery of new deposits of oil and gas reserves. Exploration costs for unsuccessful ventures are as much a part of the cost of the oil and gas discovered and produced as are the direct costs of productive wells.

"Only a portion of the oil and gas reserves discovered is likely to be produced and sold in a given year. The matching of related costs and revenues logically requires that the portion of all costs, including exploration costs, applicable to the oil and gas currently produced be charged to expense in the period of production.

"Because of the hazardous and speculative nature of the oil and gas industry, most companies have expensed their exploration costs as incurred. This practice has ignored the real capital nature of these costs, and has resulted in financial statements that do not show the total cost of the oil and gas reserves or of the current production therefrom. When exploration costs are charged to expense as incurred, profits are reduced or losses are shown in the exploratory years, because a substantial portion of the costs then being charged off does not relate to the income of the current period but to the income to be derived from future production of oil or gas."[1]

In addition, an excerpt from *Asset Accounting,* by William A. Paton, 1952 edition (pages 440 and 441) states as follows:

"In developing a wasting asset the costs of all explorations may be capitalized, even if some specific operations don't pan out, as long as the program is being carried on in a reasonable manner in the light of prevailing standards and techniques.

In the development of an oil lease, for example, several dry holes may be dug for each operation that proves to be productive. In this situation the cost of

[1] *Accounting for Oil and Gas Exploration Costs,* Subject File OI 2220, Item 124, Arthur Andersen & Co., January 1963, page 4.

> the dry holes may be regarded as a part of the cost of the activities that resulted favorably; like the falsework used in the creation of a building they represent preliminary operations necessary to the end result."

It should be emphasized, however, that this is not an endless road as the previous source cautions.

> "This interpretation, of course, must not be pushed to the point of justifying as assets the cost of development operations not warranted in the first place or long continued without success." (Paton, *Asset Accounting*, Ibid.)

Thus, while it may be appropriate to capitalize those unsuccessful ventures which can be related to the finding of successful production, this should not be interpreted as a blank check for loading the rate base with any other costs which have no bearing on productive properties.

Despite the seeming advantages of the project cost model, the record in this proceeding contains a meager amount of evidence directed to estimating a true yield rate of return and relatively much more directed to finding a rate of return under the comparable earnings test which is employed in the cross-section accounting method. With some reluctance in view of the size of the record here, I nevertheless conclude that the evidence on the critical aspect of rate of return on a true yield basis is not adequate to support the use of this method in this case.

My sole exception to the decision relates to the date of division between new and old gas which the majority fix to be January 1, 1961. I dissent to that finding because

it is fundamentally inconsistent with the very basis of the two-price system adopted by the majority. This system was first advanced by witness Kahn and applied by Roseman. Implicit and explicit in their testimony, and as the majority emphasize, the purpose of the two-price system, the purpose of a higher price for new gas, is to provide the incentive to find necessary new reserves. It is a rate designed to encourage the finding of gas in the future, for the future.

The majority's decision repeatedly emphasizes this rationale:

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> "*Looking to the future* we are establishing a pricing system that will encourage the industry to expand and perfect its ability to drill directionally so that revenues from gas consumers can increasingly be devoted to finding additional gas reserves." (p. 29) (emphasis added)
>
> "The incentive is built into the two-price system. *It provides a price for the future* related to current and future costs and payable only to producers who discover gas-well gas and dedicate their discoveries to the interstate market. (p. 29) (emphasis added)
>
> "If a one-price system were to be adopted, average historical costs — not the highest current costs — would necessarily serve as its foundation, and we have no assurance that such a price would elicit the investments at current cost levels which are needed to bring forth adequate new supplies of gas-well gas." (p. 30)
>
> ". . . if such a ceiling were fixed high enough to elicit new gas-well supplies it would result in windfall profits for all other gas and if fixed low enough

to reflect costs for old gas it would not assure adequate supplies for the future." (p. 30)

". . . bring forth needed gas supplies in the future and this fact supports our conclusion to fix a higher ceiling for new gas-well gas which will encourage exploration at deeper horizons directed toward finding gas." (p. 32)

"The separate price we fix herein for new gas-well gas in the Permian Basin should serve to furnish a practical test of whether in fact it will result in bringing forth additional supplies." (p. 32)

It requires no lengthy citations from Webster's dictionary for one to understand that incentive or encouragement relates to the future — not to the past. No matter how hard it tries, the Commission simply cannot incite or encourage a producer to find and dedicate gas to interstate commerce which he is already selling, has been selling for up to four and one-half years, and for which he would need a specific order from the Commission before being free to discontinue.

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Insofar as the majority relies on the issuance of the Policy Statement, the decision strikes a sharp blow at a basic purpose of the Natural Gas Act and the regulatory process. This Statement was issued without notice, without hearing, without any opportunity whatsoever for interested parties to comment. Reliance on such a Statement, the basis of which is devoid of support in the record, is improper. This is especially true since the Statement itself recited:

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> "It is anticipated that these differences in price levels will be reduced and eventually eliminated as subsequent experience brings about revisions in the prices in the various areas."

How ironic it must seem to the consumers of this nation that the opposite is true — that our "subsequent experience" is viewed in the light of the Policy Statement.

Looking to the future, it is easy to see that this approach will result in a crazy-quilt maze of old and new gas prices, depending on irrelevant factors such as the length of time required to try the case, and the particular test year used. Thus, "new" gas-well gas can be four and one-half years old in Permian; but in South Louisiana, assuming (but not predicting) a final decision in 1967, "new" gas-well gas will be nearly seven years old! This is some legacy.

Irrespective of how this aspect of the decision is viewed, it makes no sense. I therefore dissent to this aspect of the decision. In my view, the new gas price should relate to gas sold under contracts executed after the date of this decision.

In response to this position which was advanced by the California intervenors, the majority has no rebuttal. It simply states: "We believe, however, that the intervenors' argument proves too much . . ."

Lastly, in order to avoid any future misunderstanding, I wish to note my disagreement with the modifications of the Examiner's method of determining the old gas price as set out in the majority's decision.

In summary, this opinion is a beginning — albeit a good beginning — toward implementing our responsibilities to establish just and reasonable producer rates. I believe that with improvements, including those here suggested which the Commission indicates a willingness to consider, we will make further progress toward achieving a fair and effective system of producer regulation.

/s/ CHARLES R. ROSS
Charles R. Ross, Commissioner

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Area Rate Proceeding Claude E. Aikman, *et al.* North Central Oil Corporation (Operator), *et al.*	*Docket Nos.* G-18466, *et al.* CI60-435, *et al.*

(Issued August 5, 1965)

BLACK, Commissioner, *Concurring:*

I join in today's historic decision but wish to express briefly my separate views with regard to the Commission's determination of rate of return.

In the final analysis the allowance for rate of return is a judgment consideration. With some reluctance I concur in the Commission's exercise of judgment that on the evidence before us 12% is not excessive. I do not feel, however, that the record strongly supports such a consideration.

Because of the great numbers of producers who are affected by our decision in this proceeding and in the area rate cases to follow, the importance of a careful rate of return determination cannot be over emphasized. Translated into terms of the price of Permian gas, the difference between Staff's recommended 9.5% and the Commission's 12% is about 1.5¢ per Mcf for both new gas-well gas and flowing gas. This means about $11 million *annually* to jurisdictional purchasers of Permian gas, or nearly $4.5 million for every percentage point of rate of return.

Serious deficiencies exist in the presentation both of respondents and of the staff on the rate of return question.

The Examiner's basis for adopting a 12% rate of return is equally unsatisfactory. It is based on the earnings experience of nine "highly successful" non-integrated companies whose sales represent only about 4.5% of all jurisdictional sales made in the Permian Basin. Of these nine companies (which in my view is a woefully inadequate number to constitute a representative sampling) only three producers are primarily responsible for bringing the earnings up to the 12% average. And of these three, two were the smallest of any of the exhibit companies. Their total 1960 United States pipeline sales were, respectively, 5.2 million Mcf and 3.2 million Mcf. Their Permian Basin sales were, similarly, but an infinitesimal part of the total. It is apparently conceded that the non-integrated producer is not typical of Permian Basin gas producers;

indeed, the conclusion is unavoidable. Respondents' witness stated on the record that the typical producer is the large integrated company, and that the non-integrated producers constitute a class that is constantly diminishing in number. It is inappropriate that they should have been separated out as the standard for employment of the comparable earnings test. They simply are not comparable.

The Commission avoids any discussion of the adequacy of the non-integrated producer as a basis for comparison and instead rests our case entirely on a discussion of the risks of natural gas production cast in the most general

terms. My colleagues employ as the starting point the rates of return allowed jurisdictional pipeline companies, which fall into the range between 6.0% and 6.5%, and then seek to establish that natural gas production is a riskier business than natural gas transmission. I agree; but the translation of this added risk in terms of percentage points of return on investment has only marginal support in the record and we should acknowledge this to be the fact.

The principal risk which characterizes the operations of the independent producer is, as the main opinion properly notes, the dry hole — or non-commercial well — risk. The Commission points out that we are allowing the recovery of dryhole and associated costs as operating expenses in determining the area price for gas, but goes on to observe that "the uncertainty whether productivity will meet the industry average nevertheless remains as a risk for *each individual producer* . . . ." We are not, of course, making rates on an individual basis. A return of 12% will not obviate the risk of each individual producer in the Permian Basin; nor for that matter will a 50% return. On the Commission's reasoning it could be argued that we would have to allow a rate of return which would cover the least successful operation in the area. A basic rationale of the area-pricing approach as noted more than once in the Commission's opinion is its inherent incentive to exploration. While individual producers may not, in fact, earn a given return on their investment, by the same token no individual producer is *restricted* to a particular return. Efficient, prudent man-

agement — or just plain good luck — can produce a return which in the context of individual company rate making would be termed vastly excessive. But under our approach such companies can keep the fruits of their good fortune.

277,753

We are making rates for the industry as a whole, and the Commission properly observes that "there is a degree of predictability to production operations as evidenced by the fact that the industry as a whole has maintained over extended periods a consistent record of new discoveries and added reserves."

The main opinion effectively disposes of the producers' case for a 16-18% rate of return, and I will not comment further. I do, however, wish to address myself briefly to Staff's approach, which was joined by the California distributor intervenors, with the hope that the records in future area proceedings will provide the Commission with guidance to decide the proper rate of return on a more informed basis.

Staff's evidence, related to over-all earnings experience on total capital, includes the following:

(1) A national group of 35 companies, including both integrated and non-integrated oil and gas producers accounting for some 60% of reported 1960 pipeline sales in the United States. The simple average earnings of this group for the years 1957-1961 amounted to 9.5%, the median 8.8% and the weighted average 9.3%.

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(2) A selection of 31 companies in the Permian Basin (again including both integrated and non-integrated producers) selling 81% of all the gas sold in the Permian Basin in 1960. The same averaging techniques as applied to the national group produced returns of 9.5%, 8.9% and 9.3%, respectively.

Staff also made use of data published by financial institutions, notably the Chase Manhattan Bank and the First National City Bank of New York. The results (both for total manufacturing and for petroleum production and refining) are not markedly different than those produced by Staff's special studies. These statistics, together with information taken from the well-known *Fortune* magazine study of the 500 largest industrial companies, address themselves separately to a return on equity capital. Although today's Commission opinion does not speak in terms of a return on equity, it is nonetheless a traditional and important tool in arriving at a proper rate of return. Using Staff's selected integrated and non-integrated companies, an over-all rate of return of 12% translates into 13.5% return on equity, assuming an equity ratio of 85%.

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Chase Manhattan's group of companies (including Staff's selection) for the entire period 1934-1961 earned 9.44% on average total capital and 10.46% on average equity capital. For the five-year period 1957-1961 earnings on average total capital were 9.56% and 10.44% on average equity capital.

The First National City Bank figures, which included data for a large number of companies representing total manufacturing and a substantial group (124 in 1961) of petroleum production and refining companies, show for the petroleum companies a return of 9.66% on equity for the entire period 1925-1961 and 10.88% for the five-year period 1957-1961.

The *Fortune* study discloses an average of the mean rates of profit on equity for the petroleum industry to have been 8.88% for the years 1957-1961.

I cite these figures, not in an attempt to establish that the Commission's rate of return determination is erroneous, because I recognize that these statistics are in many respects not comparable and are likely subject to a variety of infirmities which make them inappropriate for the Commission to rely heavily on. My purpose is to indicate my belief that an over-all rate of return allowance of 12% is very probably a generous one.

In my view the principal infirmity in Staff's approach is the assumption that the unallocated earnings of the integrated producers necessarily reflects the level of earnings and thus the appropriate rate of return for the separate function of their gas production departments. Staff's position that the non-production operations of the integrated producers are riskier than those of gas production rests largely on argument. While it is true that the far-flung and diverse operations of the large integrated producers may be at least as risky over all as the production of natural gas, the record does not affirmatively support such a conclusion.

The Commission opinion asserts that "integrated returns are relevant to the instant issue" but notes that "Without a departmental segregation of costs and revenues, it is impossible to calculate production department returns."

Whether such a segregation can be made on another record or whether some other reliable means can be devised more accurately to reflect the earnings of gas producers on their jurisdictional investment, I express no opinion. I

only emphasize my strong hope that the Commission's determination of rate of return will not be understood as some kind of immutable standard which we have developed in this pilot decision, or that it will discourage the vigorous and imaginative prosecution of the rate of return case in future area rate proceedings.

Perhaps the most important single reason for a liberal rate of return allowance in the Permian Basin is that the greater part of Permian gas is substantially below pipeline quality. The Commission has provided for downward price adjustments to reflect these quality differentials with the result that much of the gas sold will not command the ceiling prices we have established.[1] The very strong likelihood that the producers will continue

[1] It should be noted, of course, that our allowance of upward adjustments in price to reflect heat value in excess of 1,050 Btu's without a corresponding downward adjustment until Btu content falls below 1,000 undeniably constitutes something of an offset to the producers' risk.

to find large amounts of substandard gas is characterized by the main opinion as a risk factor, and I agree that it is appropriate to reflect this special risk in rate of return, which may well be sufficient to justify a return allowance of 12%.

With the reservations noted above, I expressly concur.

/s/ DAVID S. BLACK
David S. Black, Commissioner

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APPENDIX A, AR61-1, *et al.*

PARTIES AND PROCEEDING CONSOLIDATED[1]

Part I

The order of December 23, 1960, made the following parties Respondents:

Abell, George T.
Ackers, D. E.
Ada Oil Co.
Adams & Ray
Aikman, Claud E.
Aldrich & Fullingim
Amerada Petroleum Corp.
American Trading & Production Corporation
Anderson-Prichard Oil Corp. (now Union Texas Petroleum, A Division of Allied Chemical Corporation)
Antweil, Morris R.
Bayview Oil Corp.
Beach, Mrs. R. G.
Bell Petroleum Co.
Benedum-Trees Oil Co.
Bird, Ethel W.
Black, Henry Drilling Co., Inc.
Blackwood & Nichols Co.
Blackwood, F. G.
Blanco Oil Co.
Bond Oil Corp.
Bradley, Albert
British-American Oil Producing Co., The
Brown & Key, Inc.

[1] With names of record as of June 30, 1965.

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Ard Drilling Co., The
Argo Oil Corporation (now The Atlantic Refining Company)
Ashland Oil & Refining Co.
Atlantic Refining Co., The
August, John J.
Aurora Gasoline Co.
Austral Oil Co., Inc.
Aztec Oil & Gas Co.

BBM Drilling Co.
BTA Oil Producers
Baker & Taylor Drilling Co.
Bakke, W. E.
Bankers Trust Co., Trustee
Barnes, J. C.
Barnes, R. C.
Barnhart Hydrocarbon Corp. (now Northwest Production Corporation)
Barnhart, Paul F.
Baxter, Murphy H.
Brown & Wheeler
Brown, Herman (now Herman Brown Estate)
Brown, James G. & Associates
Burk Royalty Co.
Burns, John J.

Cabot Carbon Co. (now Cabot Corporation)
Cahill, John T.
Callery, F. A., Inc.
Campbell, E. P.
Carper Drilling Co., Inc.
Carter, R. W.
Castleman, Barbara B. (now Barbara B. McComb)
Champlin Oil & Refining Co. (now Champlin Petroleum Co.)
Charm Oil Company
Cherry, A. W.
Christmann, John J.
Cities Service Oil Co.

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Cities Service Production Co. (now Cities Service Oil Co.)
Clark Dale Drilling Co.
Cobb, Dalton H.
Coline Oil Corp.
Colorado Oil & Gas Corp.
Coltexo Corp.
Columbian Carbon Co.
Cone, J. R.
Duncan Drilling Co.
Duncan, J. Walter, Jr.
Duncan, Raymond T.
Duncan, Vincent J.
Duncan, Walter

Elliott & Hall
Elliott, Inc. (now Elliott Oil, Inc.)
Elliott Production Co.

Cone, S. E.
Connally, J. E., d/b/a Connally Oil Co.
Constantin, E., Jr.
Constantine, S. T.
Continental Oil Co.
Coronet Oil Co.
Cosden Petroleum Corp.
Cox, John L.
Crouch, Louis
Cruce, J. L., Jr.
Crumly, L. D., Jr.
Culbertson, E. A. & Irwin, W. W.

Dalport Oil Corp.
Danglade, F. J.
Dansby, Ben, Jr.
Darneille, George J.
Daugherty, J. A.
Davis, Ethel Jo.
Davis, K. W.
Davis, K. W., Jr.
Davison, Leland
Delhi-Taylor Oil Corp. (now Tenneco Oil Company & Continental Oil Company)
Derrick, J. Roy
Dixon Management Corp.
Donnell Drilling Co.
Dorchester Corp. (now Dorchester Gas Producing Company)
Drilling & Exploration Co., Inc.

El Paso Natural Gas Products Co.

Enfield, Robert N.
Eppenauer, A. R.
Evans, David M.

Falcon Oil Corp.
Felmont Oil Corp.
Fields, Bert
Fikes, Leland
Fleet, Howard W.
Fogelson, E. E.
Foree, R. L.
Forest Oil Corp.
Fox, James O., Jr.
Franklin, John M.
French, L. R., Jr.

Gackle, Albert
General American Oil Co. of Texas
General Crude Oil Co.
George Royalty Co.
Getty Oil Co.
Gibbins, J. P.
Goldston Oil Corp.
Goldston, W. L., Estate of
Grace, Joseph Peter
Great Western Drilling Co.
Greene, Hazel
Greenbriar Oil Co. (now Lakeland Petroleum Corporation)
Gruss, Joseph S.
Gulf Oil Corp.

Halbouty, Michael T.
Hall, G. E.
Hall & Stewart Drilling Co.
Hamilton Dome Oil Co., Ltd. (now Westates Petroleum Co.)
Hammonds, George S. Hammonds, Scott (now APCO Corp.)
Hamon, Jake L.
Hanley Co.
Hanlon-Boyle, Inc.
Harper Oil Co.
Hart, Patricia Ruth Carter
Haynes & V. T. Drilling Co.
Herd Oil & Gas Co.
Hernstadt, William L.
Hiawatha Oil & Gas Co.
Hill, John H.
Hitchcock, E. C.
Hodge, T. F.
Honeyman, R. B., Jr.
Honolulu Oil Corp. (now Pan American Petroleum Corp.)
Horne, L. L. (now Estate of L. L. Horne)
Howard, Alvin H. and Vasser, D. E.
Howard, Frank A.
Hudson & Hudson, Inc.
Hudson, William A.
Hudson Co., W. H.
Humble Oil & Refining Co.
Hunt Trustee Estate, Caroline
Hunt, H. L.

Jal Oil Co., Inc. (now Joseph E. Seagram & Sons, Inc., d/b/a Texas Pacific Oil Company)
Jocelyn-Varn Oil Co.
Johnson & French Oil Co.
Johnson, J. Wes, d/b/a Tower Oil & Gas Co. of Texas
Jones, J. E., Drilling Co. (now Sohio Petroleum Co.)
Julkirk Corporation

Kay Kimbell, Oil Properties (now The Estate of Kay Kimbell)
Kelly, John M.
Kerr-McGee Oil Industries, Inc.
Kewanee Oil Co.
Kidd, Barron (now James L. Green, Jr. & Thomas Sloan)
King, Warren, Dye & Yeckel
Kirby Production Co. (now Kirby Petroleum Co.)

Ladenburg, Thalmann & Co.
Lamont, Thomas S.
Latch, Leonard
Late Oil Company
Laughlin, Phil E.
Leonard, J. M.
Leonard Oil Co.

Hunt, Lamar
Hunt, Lyda Bunker, Estate of (now Hunt Industries)
Hunt, N. B.
Hunt Oil Co.
Hunt, W. H.
Hunter, J. D., Trustee
Husky Oil Co.
Indian Royalty Co. (now Cornell Oil Co.)
Inland Natural Gasoline
Inman, Curtis R.
Limpia Royalties, Inc.
Livermore, George P.
Lomax, W. L. (Pete)* & J. P.
*now Gladys Lomax (Mrs. W. L. Pete)
Lone Star Producing Co.
Lowe, Ralph
Lundbeck, G. Hilmer, Jr.
Luse, W. P. & Jack L. Burrell, *et al.*
Lyle, W. M.

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M. W. J. Producing Co.
MacDonald Oil Corp.
Makin Drilling Co.
Maracaibo Oil Exploration Corp.
Markham, Jack
Martin, Williams and Judson
McAlester Fuel Co.
McFarlin, E. B. & Ketchum, E. P.
McGarth and Smith
McKnight, William L., d/b/a La Gorce Oil Co.
Meadows, A. H.
Mendota Oil Co.
Mertzon Corp.
Mesquite Gas Products, Inc.
Miami Petroleum Co., Inc.
Midland National Bank, The, Trustee
Midwest Oil Corp.
Miller, Charles P.
Moberly, George A.
Odessa Natural Gasoline Co.
Ohio Oil Co. (now Marathon Oil Company)
Oil Well Drilling Co.
Olsen Oils, Inc.
Olsen, R., Oil Co. d/b/a Texas Pacific Oil Company (now Joseph E. Seagram & Sons, Inc.)
O'Neill, Joseph I., Jr.
Pan American Petroleum Corp.
Parker Drilling Co. (now R. L. Parker)
Parrish, Grace Marjorie Horan
Pauley Petroleum Inc.
Payne, Clifford E.
Pecos Company
Peerless Oil & Gas Co.
Penrose, Neville G., Inc.

Moncrief, W. A., Jr.
Monsanto Chemical Co. (now Monsanto Company)
Monterey Oil Co. (now Humble Oil & Refining Company)
Moore, J. Hiram
Moore, John I.
Moore, Wayne
Moses, H. L. (now Estate of H. L. Moses)
Moses, Lucy
Mosser, H. J.
Murphy Corp.

Neill, J. P.
Neleh Gas & Oil Corp.
Nemaha Oil Co., Agent
Nolan, Wm. C. & Theodosia M., d/b/a Munoco Company
Norsworthy, Clarence L., Jr.
North Central Oil Corp.
Northern Natural Gas Producing Co.
Norwood Oil Co. and/or Norwood Drilling Co.

Phillips Petroleum Co.
Pioneer Production Corp.
Placid Oil Co.
Poff, H. Bryan
Powell, Celestine V. Trust
Powell, Doless E.
Powell, Len
Powell, Mortimer
Powell, Purnell F.
Prentice Development Corp. (now Irving D. Isko)
Pulaski, Dan J.
Pure Oil Company, The
Putnam, G. D.

Redfern Oil Co.
Reef Corporation
Regester, H. W.
Reigle, E. E., d/b/a Richmond Drilling Co.
Republic Natural Gas Co. (now Socony Mobil Oil Co., Inc.)
Resler & Sheldon
Richardson, Sid W. (now Perry R. Bass)

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Robertson, French M.
Rodman, E. G.
Rodman, E. G. and Noel, W. D.
Rodman, Late & Noel
Rodman-Noel Oil Corp. (now Rodman Petroleum Corp.)

Standard Oil Company of Texas (now Division of California Oil Company)
Starr, J. W.
Stekoll Petroleum Corp. (now Sunac Petroleum Corp.)

Rosenthal, Jerome B.
Rutherford, P. R.
Rutter & Wilbanks Bros. (now DST Exploration Corp.)
Ryan, Katherine

Samedan Oil Corp.
Sands, Caroline H. & Lloyd B.
Santa Rosa Gas Co.
Sapphire American Petroleums, Inc. (now Richard C. Davoust)
Saturn Drilling Co.
Scarborough, Warren
Schermerhorn Oil Corp.
Scott, Paul P., Trust
Secure Trusts
Sharp, J. R., Inc.
Sharples Oil Corp., The
Shea, Edward L.
Shell Oil Co.
Signal Oil & Gas Co.
Simmons, Jay
Sinclair Oil & Gas Co.
Skelly Oil Co.
Slade, Inc.
Slick Oil Corp. (now Midhurst Oil Corporation)
Snowden, James H.
Socony Mobil Oil Co., Inc.
Sohio Petroleum Co.
Southern California Petroleum Corp. (now Reserve Oil & Gas Company)
Stout, Billy J.
Street, Gordon, Inc.
Street, Gordon P.
Sun Oil Co.
Sunray Mid-Continent Oil Co. (now Sunray DX Oil Co.)
Sunset International Petroleum Corp.
Sunshine Royalty Co.
Superior Oil Co., The

TXL Oil Corp., The
Tela Corporation
Terrill, J. W.
Texaco Inc.
Texaco Seaboard, Inc. (now Texaco Inc.)
Texas Crude Oil Co.
Texas Gas Products Corp. (now Union Texas Petroleum, A Division of Allied Chemical Corporation)
Texas Gulf Producing Co. (now Sinclair Oil & Gas Co.)
Texas-Hanover Oil Co.
Texas Hydrocarbon Co. (now Union Texas Petroleum, A Division of Allied Chemical Corporation)
Texas National Petroleum Co. (now Union Oil Co. of California)

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Southern Petroleum Exploration Inc.
Southern Union Gas Co. (now Southern Union Production Company)
Southland Royalty Co.
Spence, Aurelia, Mrs.
Texas Pacific Coal & Oil Co. (now Joseph E. Seagram & Sons, Inc. d/b/a Texas Pacific Oil Company)
Thornbury, D. H.
Three States Natural Gas Co.

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Tidewater Oil Co.
Todd, W. L., Jr.
Tres Oil Co.
Tri-Service Drilling Co.
Trice Production Co.
Tucker, R. C.
Turner, Fred, Jr.
Two States Oil Co.

Union Oil Company of California
United States Smelting Refining and Mining Co.

VEM Oil, Inc.
Vaughn, G. H., Jr. and Jack C. Vest, Earl & Sam; Dorbandt, Arnett; Ross, Bert

Warren Petroleum Corp.
Watts, Ed. E.
Weier Drilling Co. (now A. D. Weier, Jr., et al.)
Welborn, J. M.
West Texas Gathering Co.
Westbrook-Thompson Holding Corp.
Western Development Company of Delaware
Western Natural Gas Co. (now Sinclair Oil & Gas Company)
Western Oil Fields, Inc.
Western Petroleum Co. (now CRA, Inc.)
Westlund, Carl J., Inc.
Willetts, Elmore A., Jr. and Craig, Earle M., Jr.
Williams, D. A.
Williamson, J. C.
Wolfson, Reuben I. & Sam
Wrightsman, Charles B. (now Wrightsman Petroleum Company)

Young, Marshall R.

Zachary, J. M.

Part II

The following Respondents were eliminated as parties to the proceeding by subsequent orders of the Commission:

American Trading & Production Corp.
Barnes, R. C.
Bayview Oil Corporation
Bond Oil Corporation
Coline Oil Corporation
Columbian Carbon Company
Coronet Oil Company
Dansby, Ben, Jr.
Falcon Oil Corporation
Felmont Oil Corporation
Greene, Hazel
Halbouty, Michael T.
Hanlon-Boyle, Inc.
Howard, Alvin H. & D. E. Vasser
Indian Royalty Company
Kerr-McGee Oil Industries, Inc.
Maracaibo Oil Exploration Corp.
Mosser, H. J.
Poff, H. Bryan
Ryan, Katherine
Snowden, James H.
Tela Corporation
Terrill, J. W.
Young, Marshall R.

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Part III

The following proceedings involving proposed increases in rates were consolidated. Proceedings marked with "*" are consolidated only insofar as they pertain to the Permian Basin, New Mexico and Texas Railroad Commission Districts Nos. 7-C and 8 areas. Regarding proceedings marked with "**", there remains open the question of the contractual support of the respondents to make the increased rate filings. This question will be determined in Amerada Petroleum Corporation, *et al.*,

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Docket Nos. G-16117, et al., and *Phillips Petroleum Company*, Docket Nos. G-11217, *et al.*

Producer	Docket No.
Aikman, Claud E.	G-18466, R160-73
Amerada Petroleum Corporation	G-19488**, G-19577**, G-20390, RI60-353
Amerada Petroleum Corporation, *et al.*	G-19489**
Amerada Petroleum Corporation (Operator), *et al.*	G-19490**, RI60-354
Apco Oil Corporation (formerly George S. Hammonds)	G-16520
Apco Oil Corporation, *et al.* (formerly Scott Hammonds, *et al.*)	G-16521
Ard Drilling Company, The	RI60-90
Ashland Oil and Refining Company	RI60-329
Atlantic Refining Company, The (formerly Argo Oil Corporation)	RI60-177
Austral Oil Company, Inc., Agent for Oil Participants, Inc.	G-19540**

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Producer	Docket No.
Aztec Oil and Gas Company	RI61-201
BTA Oil Producers (Operator), *et al.*, and Shell Oil Company (formerly BTA Oil Producers (Operator), *et al.*)	G-20525

Bakke, W. E. (Operator), *et al.*, Sohio Petroleum Company (Operator), *et al.*, and Abel & Bancroft (Operator), *et al.* (formerly W. E. Bakke, (Operator), *et al.*)	G-16477**
Barnhart, Paul F., *et al.*	G-13985, G-14017
Barnhart, Paul F.	G-14018
Baxter, Murphy H. (Operator), *et al.*	G-14181
Benedum-Trees Oil Company	G-12881**, G-20522
Bird, Ethel W., *et al.*	RI60-190
Black, Henry, Drilling Company, Inc. (Operator), *et al.*	RI60-105
Blackwood, F. G., *et al.*	G-18515
Blanco Oil Company, *et al.*	G-20402
British-American Oil Producing Company, The	G-14028, G-19254**
Brown, H. L., Estate, *et al.* (formerly Brown and Wheeler, *et al.*)	RI60-4
Brown, Herman, Estate (formerly Herman Brown)	RI60-82
Brown, James G. & Associations (Operator), *et al.*, and Tamarack Petroleum Company, Inc., Agent, *et al.*	RI60-346

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Producer	Docket No.
Cabot Corporation (SW) (formerly Cabot Carbon Company)	G-18842**

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Cabot Corporation (SW) and Sinclair Oil & Gas Company (formerly Cabot Carbon Company)	G-18844**, RI60-27
Callery, F. A., Inc., *et al.*	G-19645**, RI60-395
Charm Oil Company	G-19491**, RI60-206
Cities Service Oil Company	G-20393, G-20395
Cities Service Oil Company (Operator), *et al.*	G-20394
Cities Service Oil Company (formerly Cities Service Production Co. (Operator), *et al.*)	G-20396
Connally, J. E. d/b/a Connally Oil Company (Operator), *et al.*	RI60-104
Constantine, S. T. (Operator), *et al.* and Roy E. Kimsey, Jr. (Operator), *et al.* (formerly S. T. Constantine (Operator), *et al.*)	RI60-43
Continental Oil Company	RI61-87
Continental Oil Company (Operator), *et al.*	RI61-86
Cox, John L.	RI60-115, RI60-321
Cox, John L. (Operator), *et al.*	RI60-272

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Producer	Docket No.
Crumly, L. D., Jr.	RI61-42
Crumly, L. D., Jr. and Tom Schneider (formerly L. D. Crumly, Jr.)	G-20530
Culbertson, E. A. and W. W. Irwin	RI60-153

Dalport Oil Corporation, *et al.*	G-20397
Dalport Oil Corporation (Operator), *et al.*	G-20398
Davidson, Leland, *et al.*, Humble Oil & Refining Company and Continental Oil Company (formerly Leland Davidson, *et al.*)	RI60-467
Davidson, Leland, *et al.* and Humble Oil & Refining Company (formerly Leland Davidson, *et al.*)	RI61-54
Davoust, Richard C. (formerly Stanton Oil Company, Ltd.)	RI61-106
Donnell Drilling Company	G-14736
Dorchester Gas Producing Company (Operator) (formerly Dorchester Corporation (Operator))	RI60-11
Elliott, Oil Inc. (formerly Elliott, Inc.)	RI60-228
Elliott Production Company	RI60-212
Enfield, Robert N.	RI60-87

277,766

Producer	Docket No.
Eppenauer, A. R.	G-20524
Fleet, Howard W., *et al.*	RI60-157
Foree, R. L.	G-20539
Forest Oil Corporation	RI60-107
French, L. R., Jr.	G-19726
French, L. R. Jr. (Operator), *et al.*	G-17347**, G-19725, RI60-9
Gackle, Albert (Operator), *et al.*	G-13940, G-14045 RI60-151

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Gackle, Albert, Agent, (Operator), *et al.*	RI60-117
General American Oil Company of Texas	RI60-248
Getty Oil Company	G-16533**, RI60-72**, RI61-19
Goldston, W. J., Independent Executor of Estate of W. L. Goldston, Deceased, *et al.*	RI60-343
Greene, James L., Jr., *et al.* (formerly Barron Kidd)	RI60-109[1]
Gruss, Joseph S.	RI60-74, RI 60-461
Gulf Oil Corporation (Operator), *et al.*	G-20399
Gulf Oil Corporation	G-20400
Hall, G. E. (Operator), *et al.*	G-15175

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Producer	Docket No.
Hamon, Jake L. (Operator), *et al.*	G-18327**, RI60-112
Hamon, Jake L.	RI60-106
Hanley Company (Operator), *et al.*, DST Exploration Corporation (Operator) *et al.*, and Humble Oil & Refining Company (formerly Hanley Company)	RI60-76
Hanley Company	RI60-75
Hanley Company, *et al.*	RI60-77
Harper Oil Company (Operator), *et al.*	RI60-200

[1] Peter B. Smith has filed a motion to be made respondent in this proceeding.

Herd Oil and Gas Company	G-18769**
Horne, L. L., Estate of (formerly L. L. Horne)	G-18268
Hudson, W. H. Company	RI60-156
Humble Oil and Refining Company (Operator), *et al.*	G-16415**[2], G-18172**, RI60-443[2], RI60-473
Humble Oil & Refining Company (formerly Monterey Oil Company)	RI60-42
Humble Oil & Refining Company	G-16416**, G-19487**, RI60-430 RI60-444, RI60-447
Humble Oil & Refining Company (Operator), *et al.* (formerly Monterey Oil Company (Operator), *et al.*)	G-17799**, G-18568**, RI60-28, RI60-80
Hunt, H. L.	G-16421**, G-18554, G-20527, RI60-84, RI60-324
Hunt, H. L., *et al.*	RI60-110

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Producer	Docket No.
Hunt-Margaret, Lyda, Trust, *et al.* (formerly Estate of Lyda Bunker Hunt)	G-18556
Hunt Industries (formerly Estate of Lyda Bunker Hunt)	G-16423**, G-20535

[2] Amerada Petroleum Corporation has filed a motion to be made a co-respondent in this proceeding.

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Hunt, Lamar	G-16418**, G-17424**, G-18847, G-20528
Hunt, N. B.	G-16420**, G-16478**, G-18557, G-20533
Hunt, W. H.	G-16419**, G-17425**, G-18848, G-20534
Husky Oil Company (formerly Husky, Inc.)	G-19722
Inland Natural Gasoline	G-19992**, RI60-91
Jocelyn-Varn Oil Company (Operator), *et al.*	RI60-36
Johnson, J. Wes d/b/a Tower Oil & Gas Company of Texas, Jeanne Kerbs, W. A. Morel and Walter E. Heller & Company (formerly J. Wes Johnson d/b/a Tower Oil & Gas Company of Texas)	RI60-276
Jones, J. E., Drilling Company (Operator, *et al.*, and Sohio Petroleum Company (Operator), *et al.* (formerly J. E. Jones Drilling Company (Operator), *et al.*)	G-14762
Kewanee Oil Company	G-15235, RI61-155
Kimbell, Kay The Estate of, *et al.*, and Chase Petroleum Company (Operator), Agent for John M. Clark, *et al.* (formerly Kay Kimbell Oil Properties, *et al.*)	G-20538

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Producer	Docket No.
Kirby Petroleum Company (Operator), *et al.* (formerly Toklan Production Company, *et al.*)	G-13838, RI60-311
Lakeland Petroleum Corporation (formerly Greenbrier Oil Company and Theo. Hamm Brewing Co.)	RI60-22, RI60-23
Latch, Leonard, *et al.*	RI60-328
Late Oil Company (Operator), *et al.*	G-14495
Leonard Oil Company	RI60-44, RI60-113
Leonard, J. M.	RI61-226
Limpia Royalties, Inc.	G-14761
Luse, W. P., *et al.*, and Jack L. Burrell (Operator), *et al.* (formerly W. P. Luse, *et al.*)	RI60-37
Lyle, W. M., *et al.*	G-20419
MWJ Producing Company (Operator), Agent	RI60-88, RI60-188
MacDonald Oil Corporation (Operator), *et al.*	RI60-258, RI60-419
Marathon Oil Company (formerly The Ohio Oil Company)	RI60-260
Marathon Oil Company (Operator), *et al.* (formerly The Ohio Oil Company (Operator), *et al.*)	RI60-259
Markham, Jack, *et al.*	RI60-222
Martin, Williams & Judson (Operator), *et al.*	RI60-89

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Producer	Docket No.
McAlester Fuel Company	G-19324
McFarlin, E. B., and Ketchum, E. P.	G-13161**, RI60-24
McGrath & Smith (Operator), *et al.*	RI60-316
McGrath & Smith, Inc., Agent (Operator), *et al.* (formerly Carl J. Westlund, Inc. (Operator), *et al.*)	RI60-196
McKnight, William L. d/b/a La Gorce Oil Company, *et al.*	RI60-315
Meadows, A. H.	RI60-33
Mendota Oil Company	RI60-314, RI60-351
Midhurst Oil Corporation	RI60-103
Monsanto Company (formerly Monsanto Chemical Company)	RI60-122
Moore, J. Hiram, *et al.*	RI60-3
Moore, Wayne, *et al.*	G-20416
Northwest Production Corporation (formerly Barnhart Hydrocarbon Corporation)	G-16417**, G-20418
Nueces Company, The (Operator) (formerly Santa Rosa Gas Company (Operator))	G-17165**, G-20412
Odessa Natural Gasoline Company	RI60-5
Oil Well Drilling Company, *et al.*	RI60-152

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Producer	Docket No.
O'Neill, Joseph I., Jr., *et al.*	RI60-320
Pan American Petroleum Corporation	G-16480**, G-16532**, G-19998**, G-20452**, RI61-43, RI61-58
Pan American Petroleum Corporation (Operator), *et al.*	G-20008**, RI61-45
Pan American Petroleum Corporation (Operator)	G-16481**, G-20006**, RI61-53
Pan American Petroleum Corporation, *et al.*	G-20007**
Pan American Petroleum Corporation and Hanley Company (Operator), *et al.* (formerly Pan American Petroleum Corporation)	RI61-44
Pan American Petroleum Corporation (formerly Honolulu Oil Corporation)	G-16425**, RI60-32
Pan American Petroleum Corporation (Operator), *et al.* (formerly Honolulu Oil Corporation (Operator), *et al.*	G-17059
Pauley Petroleum Inc., *et al.*	G-20529
Pecos Company	RI60-34
Pecos Company (Operator)	RI60-35
Peerless Oil & Gas Company and The Fluor Corporation, Ltd. (formerly Peerless Oil & Gas Company)	G-20401

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Producer	Docket No.
Phillips Petroleum Company	G-11849, G-13734**, G-15315**, G-18207**, G-18215**, G-20405, G-20523, RI60-2, RI60-15
Phillips Petroleum Company (Operator), *et al.*	G-14006, G-15314**, G-18206**, G-18418**, G-20403*
Phillips Petroleum Company (Operator)	G-14115**, G-17071, G-18417**, G-20404, G-20417, RI61-30
Pure Oil Company, The	G-16800**, G-17930, G-17937**, G-20005, G-20280, RI60-91, RI60-418
Redfern Oil Company	G-18770**
Reef Corporation (Operator), *et al.*	RI61-66
Reigle, E. E., d/b/a Richmond Drilling Company	RI60-38
Reserve Oil & Gas Company, *et al.*, Husky Oil Company, Haynes & V. T. Drilling Company and Reserve Oil & Gas Company (formerly Southern California Petroleum Corporation)	RI60-13
Reserve Oil & Gas Company (Operator), *et al.* (formerly Southern California Petroleum Corporation)	RI60-12
Resler & Sheldon (Operator), *et al.*	G-19492

Robertson, French M. (Operator), *et al.*	RI61-244
Robertson, French M. & J. P. Bryan (formerly G. Stratton, Jr. (Operator), *et al.*	G-16535
Rodman, E. G. (Operator), *et al.*	G-19994, RI60-7
Rodman, E. G. & W. D. Noel	RI60-6
Rodman, Late & Noel[3]	G-19952

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Producer	Docket No.
Rodman Petroleum Corporation (Operator), *et al.* (formerly Rodman-Noel Oil Corporation)	G-19996
Rosenthal, Jerome B., *et al.*	RI60-414
Rutter & Wilbanks Brothers (Operator), *et al.* and DST Exploration Corporation (formerly Rutter & Wilbanks Brothers (Operator), *et al.*)	RI60-155
Schermerhorn Oil Corporation, *et al.*	RI60-40, RI60-81
Schemerhorn Oil Corporation	RI60-41
Scott, Paul P. Trust, *et al.*	RI60-108, RI61-98

[3] Motion filed of change of name to "Rodman and Late."

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Seagram, Joseph E. & Sons, Inc., d/b/a Texas Pacific Oil Company (Operator), *et al.* (formerly Jal Oil Company, Inc. (Operator), *et al.*)	RI60-256, RI60-350, RI60-380
Seagram, Joseph E. & Sons, Inc., d/b/a Texas Pacific Oil Company (formerly Jal Oil Company, Inc.)	RI60-362, RI60-442
Seagram, Joseph E. & Sons, Inc., (formerly Olsen Oils, Inc.)	G-20003
Seagram, Joseph E. & Sons, Inc., d/b/a Texas Pacific Oil Company (Operator) *et al.* (formerly Olsen Oils, Inc. (Operator), *et al.*)	G-20002, RI60-118
Seagram, Joseph E. & Sons, Inc., d/b/a Texas Pacific Oil Company (formerly Texas Pacific Coal & Oil Company)	RI60-453, RI60-469
Seagram, Joseph E. & Sons, Inc., d/b/a Texas Pacific Oil Company (Operator) *et al.* (formerly Texas Pacific Coal & Oil Company (Operator), *et al.*)	RI60-470
Secure Trusts	G-16424**, G-18558, G-20536
Sharples & Company Properties (Operator), *et al.* (formerly Sharples Oil Corporation)	G-14253, G-14624

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Producer	Docket No.
Signal Oil & Gas Company (Operator), *et al.*	RI60-219
Signal Oil & Gas Company (Operator), *et al.* (formerly John I. Moore, *et al.*)	RI60-120
Signal Oil & Gas Company, *et al.*	RI60-305
Simmons, Jay, *et al.*	RI60-154, RI60-197
Sinclair Oil & Gas Company	G-16534**, G-16956, G-18326**, G-19723**
Sinclair Oil & Gas Company (Operator), *et al.*	G-20082*
Sinclair Oil & Gas Company, *et al.*	G-19724
Sinclair Oil & Gas Company and NE-O-TEX Corporation (formerly Sinclair Oil & Gas Company)	RI60-31
Sinclair Oil & Gas Company (Operator), *et al.* (formerly Texas Gulf Producing Company (Operator), *et al.*)	G-14066, G-16537**, RI60-25
Sinclair Oil & Gas Company and Amerada Petroleum Corporation (formerly Sinclair Oil & Gas Company)	G-20580, RI61-56*
Sinclair Oil & Gas Company (Operator), *et al.* (formerly Western Natural Gas Company)	G-19252, RI60-45

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Sinclair Oil & Gas Company (formerly Texas Gulf Producing Company)	RI60-26
Skelly Oil Company	RI61-88
Slade, Inc.	RI60-147
Slade, Inc. (Operator), *et al.*	RI60-179

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Producer	Docket No.
Socony Mobil Oil Company, Inc.	G-12981**, G-12982**, G-13030**, G-15448**, G-15449**, G-15995**, G-20407, RI60-46
Socony Mobil Oil Company, Inc. (Operator)	G-20408
Socony Mobil Oil Company, Inc. (Operator), *et al.*	RI61-94
Socony Mobil Oil Company, Inc. (formerly Republic Natural Gas Company)	RI60-10
Socony Mobil Oil Company, Inc., (formerly Republic Natural Gas Company, *et al.*)	G-13311**
Socony Mobil Oil Company, Inc. (Operator), *et al.* and The Atlantic Refining Company (formerly Socony Mobil Oil Company, Inc. (Operator) *et al.*)	G-20406
Sohio Petroleum Company (Operator), *et al.*	RI60-8
Southern Union Production Company (formerly Southern Union Gas Company)	G-19483**, RI60-242

Southland Royalty Company	G-19727**, RI60-119, RI60-148, RI61-50
Southland Royalty Company (Operator), *et al.*	RI60-306
Standard Oil Company of Texas, a Division of California Oil Company	G-14059**, G-19583**, RI60-164**, RI60-337**, RI61-161
Standard Oil Company of Texas, a Division of California Oil Company	G-13187**, G-19664**, RI60-338

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Producer	Docket No.
Street, Gordon, Inc.	RI60-86
Street, Gordon, Inc. (formerly Gordon P. Street)	RI60-85
Sunac Petroleum Corporation (Operator), *et al.*, and DST Exploration Corporation (Operator), *et al.* (formerly Stekoll Petroleum Corporation (Operator), *et al.*)	RI60-114
Sun Oil Company	RI60-123
Sun Oil Company (Operator), *et al.*	RI60-124
Sunray DX Oil Company (formerly Sunray Mid-Continent Oil Company)	G-13160**, G-16884**, G-19090**, G-20537, RI60-14, RI60-29, RI60-101
Superior Oil Company, The	G-12949**, G-12950**[4], G-15358**[4], G-18771, G-20075

[4] Amerada Petroleum Corporation has filed a motion to be made a co-respondent in this proceeding.

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Tenneco Oil Company and Continental Oil Company (formerly Delhi-Taylor Oil Corporation)	G-19728**, RI60-278, RI60-322
Texaco Inc. (formerly The TXL Oil Corporation)	RI60-224
Texaco Inc.	G-16414**, G-17159**, RI60-132**, RI60-137**, RI60-142**, RI60-466, RI61-33, RI61-74
Texaco Inc. (formerly Texaco Seaboard Inc.)	G-14194

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Producer	Docket No.
Tidewater Oil Company	G-14061**, G-14185**, G-16259**, RI60-71**, RI61-17
Tidewater Oil Company (Operator), *et al.*	G-16260**, RI60-70**, RI61-18
Todd, W. L., Jr., *et al.*	G-20415
Tri-Service Drilling Company	RI60-454
Trice Production Company (Operator), *et al.*	RI60-234
Turner, Fred, Jr.	RI60-83
Two States Oil Company	RI60-39
Union Oil Company of California (formerly Texas National Petroleum Company)	RI60-325, RI61-27
Unión Oil Company of California	G-13997, RI60-174, RI60-438

Union Oil Company of California (formerly Texas National Petroleum Company (Operator), *et al.*)	RI61-26
Union Texas Petroleum, a Division of Allied Chemical Corporation (Operator), *et al.* (formerly Texas Gas Products Corporation (Operator), *et al.*)	G-16888**, G-18952**, G-20420
Union Texas Petroleum, a Division of Allied Chemical Corporation (formerly Texas Hydrocarbon Company)	G-16889**, G-18951**, G-20421
Union Texas Petroleum, a Division of Allied Chemical Corporation (formerly Anderson-Prichard Oil Corporation)	G-19644, G-19651, RI60-121, RI60-149
Union Texas Petroleum, a Division of Allied Chemical Corporation (Operator), *et al.* (formerly Anderson-Prichard Oil Corporation (Operator), *et al.*)	G-19638, RI60-150

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Producer	Docket No.
Vaughn, G. H., Jr. & Jack C., *et al.*	G-20413
VEM Oil Inc. and B. W. P., Inc. (formerly VEM Oil, Inc.)	RI60-116
Warren Petroleum Corporation	G-12842**, G-15311**, G-16114**, G-18560**, G-20410

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Warren Petroleum Corporation (Operator)	G-15304**, G-15310**, G-18467**, G-18471**, G-18517**, G-20409
Weier, A. D., Jr. *et al.* (formerly Weier Drilling Company) (Operator), *et al.*	RI60-261
Westates Petroleum Company (formerly Hamilton Dome Oil Company, Ltd.)	G-20414
Western Petroleum Company and CRA, Inc., *et al.* (formerly Western Petroleum Company)	G-20411
Wilshire Oil Company of Texas (formerly Nemaha Oil Company)	RI60-78
Wilshire Oil Company of Texas, Agent for the Estate of Herbert W. Grindal, *et al.* (formerly Nemaha Oil Company, Agent, *et al.*)	RI60-79
Wrightsman Investment Company (formerly Charles B. Wrightsman)	G-20540

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Part IV

The following certificate proceedings were also consolidated:

Producer	Docket No.
Brown, Robert T., Operator, *et al.*	CI61-733
North Central Oil Corporation (Operator), *et al.*	CI60-435

Nortex Oil and Gas Corporation & Socony Mobil Oil Company — Temporary issued 7/10/64 — CI61-34

TXL Oil Corporation, The (Texaco Inc. substituted as party 6/31/62) — CI61-879

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Part V

Parties whose petitions to intervene were granted by orders dated May 31, 1961 and July 26, 1961:

Public Service Commission of Wisconsin

Minneapolis Gas Company

Public Utilities Commission of State of California and People of the State of California

David Fasken

Delta Drilling Company

W. H. Black (Operator)

DST Exploration Company

G. E. Marsh, II

J. H. Vandenbark (Operator)

The City of Los Angeles

Abel & Bancroft

James L. Green, Jr. and Thomas M. Sloan

J. H. Bartley, Norman Bock, A. W. Lasher, Jr. & William Moss

Dekalb Agricultural Association, Inc.

The State of Wisconsin

West Central Texas Oil and Gas Association

Iowa Public Service Company

Texas Independent Producers and Royalty Owners Association

City and County of San Francisco, California

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San Diego Gas & Electric Company
Pacific Gas and Electric Company
State of New Mexico
Jeanne E. Krebs
Big Chief Drilling Company
American Liberty Oil Company
El Paso Natural Gas Company
Transwestern Pipeline Company
Minnesota Valley Natural Gas Company
Iowa Electric Light and Power Company
King-Stevenson Oil Company, Inc.
Pacific Lighting Gas Supply Company, Southern California Gas Company and Southern Counties Gas Company of California
Service Drilling Company
The State of Texas
Northern States Power Company
E. R. Bahan
Central Natural Gas Company
Metropolitan Utilities District of Omaha
Independent Petroleum Association of America
Fuels Research Council, Inc.
The City of San Diego

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Woolaroc Oil Company
Iowa Power and Light Company
Central Electric and Gas Company (now Western Power & Gas Company)
Northern Natural Gas Company
J. M. Armstrong & W. A. Yeager
C. A. McClintic
Delfern Oil Company

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APPENDIX B, Docket Nos. AR61-1, et al.

The following discussion from the presiding examiner's initial decision, Appendix B, pages 84-85, is adopted by the Commission:

E. DRY HOLE COSTS

Roseman and Park divide dry hole costs on the basis of the relationship between successful oil and gas well footage averaged over a period of years. While this method might not be suitable for dealing with the dry hole costs of an individual company due to the variations in annual success ratios and productivity of successful drilling, as Respondent witness Porter showed, these variations tend to be minimized in the magnitude of the industry's total effort over a period of years. Therefore these witnesses' basic approach is sound on the industry level.

For the period 1955-60, Park determines the average annual dry hole footage and successful footage, separately for exploratory and developmental footage. This shows that 6.4 feet of dry holes were drilled for each successful exploratory foot, and 0.3 feet per successful developmental foot. These numbers are multiplied by the average annual gas footage, broken down between exploration and development, thus arriving at the total dry hole footage to be borne by gas well gas. The total is then multiplied by the JAS 1960 average cost per foot for dry holes. The result is divided by the average annual reserve additions of gas well gas to produce 1.56 cents per Mcf for dry holes. Park thus allocates dry hole costs

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in proportion to the relationship between successful gas footage and total successful footage.

Roseman also divides his dry hole footage between gas and oil in proportion to successful gas and oil footage, separately for "wildcat"[3] and other footage. He derives a combined ratio of 0.898 feet of dry hole per successful gas well footage as the weighted average for the period 1951-61. (The corresponding ratio for Park for the period 1955-60 is 0.891.) Then he takes the cost per dry hole foot drilled from the Census for 1958 and after adjustment computes the cost per Mcf of dry holes drilled.

Roseman makes three adjustments to the dry hole foot cost figure of $8.91, the Census figure for 1958.

The Appendix figures show a decline of 3.5 percent in dry hole drilling costs from the peak year 1958 to 1960. For the reasons previously given, it is appropriate to adjust the 1958 Census level by the trend actually experienced by the constant sample of companies in the Appendix. This adjustment reduces the cost per dry hole foot to $8.60 per foot.

Roseman makes a second adjustment to take account of the fact that gas wells are typically deeper and therefore more expensive than oil wells. Using the *Oil and Gas Journal* figures which show drilling footage by depth and by well type, and Appendix data which shows the

[3] *World Oil*, on which Park and Roseman rely for allocating dry hole costs, provides a breakdown between "wildcat" and total drilling. It appears that the term exploratory as used here by Park corresponds to the term "wildcat" used in *World Oil*.

Appendix cost per foot for 1960 in the various depth ranges, he finds that the average cost per foot of dry holes allocated to gas was 12 percent greater than it would have been, if depth had been disregarded.

Again, analysis of the figures allocated to gas by Roseman on the basis of successful wells at various depth ranges, indicates that the footage allotted to gas is 4 percent less than if, disregarding depth ranges, the allocation were made simply on the ratio of total successful gas well to oil well footage. This

is a statistical indication that deeper wells tend to have a higher success ratio. The combination of the second and third adjustments, an increase in cost of 12 percent for greater depth and a reduction of 4 percent for greater success ratio, results in an upward adjustment of 8.28 percent.

The adjusted cost per foot figure is $9.31 per foot which produces a cost of 1.42 cents per Mcf.

Roseman's trended Census cost per foot is preferred to Park's JAS cost. The JAS sample average cost reflects the overrepresentation of large producers, their deeper than average drilling, and consequent higher than average cost per foot. Roseman's adjustments which reflect the effects of depth and success ratios for gas wells are sound refinements. For these reasons Roseman's estimate of 1.42 cents is accepted.

The following discussion from the presiding examiner's

initial decision, Appendix B, pages 80-83, is adopted by the Commission:

B. LEASE ACQUISITION COSTS

Park, Roseman and Sherwin estimate lease acquisition costs for gas well gas on the basis of the relationship between lease acquisition costs and successful well drilling costs.

Data on leasehold acquisition costs in relation to successful drilling costs are available from the Staff Appendices B and C, the *Joint Association Survey* and the Chase Manhattan Bank's *Annual Analysis of the Petroleum Industry 1961* (Chase). Ratios between leasehold acquisition costs and successful drilling costs cannot be computed from the Chase data alone because the Chase drilling costs include lease equipment costs which cannot be broken out. However, the Chase figures for lease acquisition costs are separate. Roseman used this data and related it to the trended Census drilling costs (the Chase-Census results). The ratios from the above sources are shown for recent years below.

There is difficulty in using the data on this subject.

1. Lease acquisitions vary considerably from year to year and are significantly influenced by Federal offshore lease sales at which large blocks are sold at irregular intervals, chiefly to large producers. As shown below, the expenditures for leaseholds by the small producers have been stable in relation to drilling costs, while the expenditures of the large producers have varied significantly. Given the variability in the ratios, it is desirable to consider the results

Ratio of lease acquisition costs to successful well costs (percent)

	JAS	Roseman	Staff summaries	
			Respondents Over 10 million	Respondents Under 10 million
	(1)	(2)	(3)	(4)
1955	36	36	N.A.	N.A.
1956	29	28	41	28
1957	N.A.	20	27	23
1958	N.A.	23	39	24
1959	30	28	43	28
1960	38	36	67	28
1961	26	24	N.A.	N.A.
Weighted average	33	[1]26.4	42	26

[1] Years 1957, 1958, 1959, 1960.

Source:

(1) Joint Association Survey, 1961; and 137/14381.

(2) Exhibit 224, Sch. 5; and 173/20614.

(3) Exhibit 149, p. 32.

(4) Exhibit 149, p. 45 and Exhibit 153, p. 12. Data in Exhibit 153 adjusted to separate out related lease equipment from reported total of "well equipment and related lease equipment."

N.A. = Not available.

for a number of consecutive years. The JAS does not report any results for 1957 and 1958. The Chase-Census figures are available over a span of years and the Appendix data covers 1956-60.

* * *

To relate lease acquisitions to drilling cost, Roseman estimated drilling costs for oil and gas separately from the

Census for 1958 and trended these results on the basis of the Appendix A experienced costs from 1957-60. The per foot results for oil and gas were applied to the total footage drilled of oil and gas wells as reported in *World Oil*, to obtain the total drilling costs for each year. As previously discussed, trending the drilling data on the basis of the trends shown in the Appendix A is a sound method for determining trends in drilling costs. Trending the 1958 drilling costs downward increases the ratio of lease acquisition costs to drilling costs. Roseman then relates the industry wide lease acquisition data of the Chase analysis to the trended industry drilling costs. He considers the annual ratios from 1955-61 * *

and correctly found no trend. He then determines the weighted average ratio for the years 1957-60 to be 26.4 percent, which provides a representative sample of years in which lease acquisition costs were at high and low levels. Applying this percentage to his drilling cost of 2.88 cents per Mcf for successful gas wells, determined from the first step, yields 0.76 cents per Mcf.

Sherwin's estimate for the relationship between lease acquisition costs and successful well costs is in the range of 33 to 37 percent. He begins with the Appendix data which for the years 1956-60 average 42 percent for the large producers and 26 percent for the small producers. He also considers the lower estimates of JAS and Chase. JAS doesn't cover the years 1957 and 1958, which the other estimates show were the two lowest years in any of the series. It is evident from the preceding table that for all the years JAS is available 1955, 1956, 1959, 1960,

1961, its ratios are never more than two percentage points higher than the Chase-Census ratios.

Sherwin's major reliance is the Appendix data for the large producers. The ratios for these large producers are much higher than either the JAS or the Chase-Census ratios. The ratio of 67 percent for 1960 is 29 percentage points above the JAS figure for that year and 30 points above the Chase-Census ratio. This last variance is probably due in part to extensive purchases by large producers of offshore leases at the federal sales occurring that year. Such lease sales are in the main confined to large producers and their affiliates, and are generally in large amounts. These transactions are reflected to a greater degree in the Appendix results for the large producers than in the JAS or the Chase-Census results, because the national Appendix data underrepresent the small companies to a greater extent than the other two. Sherwin's upper limit of 37 percent is based in the main on an apparent trend in the results for the large Appendix producers for 1958, 1959 and 1960, 39 percent, 43 and 67 percent, respectively, although on other occasions he criticizes the use of Appendix data even for trending purposes. During this same period there is no trend in the ratios of the Appendix small producers. That three years is too short a period to establish a trend for this purpose is shown by the downward movement in 1961 for both the JAS and the Chase-Census ratios. In March 1962 there were large sales of offshore leases, and the 1962 data will probably reflect this, but the whole picture still indicates variability but no trend. Sherwin's estimate,

being based largely on the least representative data, is rejected.

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Witness Park combines his estimate for lease acquisitions with that for lease facilities. He estimates that these two items should amount to 50 percent of his already determined drilling costs per Mcf. Park's estimate is based in large part on his judgment and experience as an official of Texaco. He considered the JAS average results for these items for the years when this survey was published and the 1956-60 Staff average results for all Appendix B producers. Both show a ratio of 59 percent for lease acquisition costs and lease production facilities in relation to drilling costs. Park first adjusts this percentage downward to reflect the fact that lease production facilities are more extensive on oil leases. He then adjusts the percentage upward to a lesser extent to take account of the fact that gas wells are more widely spaced and drain a greater acreage than oil wells. These two judgment adjustments resulted in a net downward adjustment to 50 percent, of which Park assigns 40 percent for lease acquisitions and 10 percent to lease production facilities.

Park's 40 percent figure is higher than the JAS average ratio. Moreover, as previously noted, the JAS was not published for the years which the Chase-Census and Appendix ratios indicate were the two lowest in their respective series, 1957 and 1958. And, as previously noted, the JAS average is probably too high because it is overweighted by large companies whose acquisition

costs are a higher proportion of well drilling costs than is true for the small companies. The average ratio for the years 1956-60 for all the Appendix B companies is 42 percent. The upward bias in the ratios resulting from the unrepresentativeness of Staff's companies has been discussed.

Park's upward adjustment is based on his experience that the spacing of gas wells is typically wider than for oil and therefore uses more acreage. He also gives his opinion that gas acreage is not correspondingly cheaper than oil acreage. He cites no study or data in support of his conclusion. He does not appear to have considered the relative values of oil or gas prospects. Park does not mention the factor that the drilling cost for gas wells is typically greater than for oil wells because of the greater depth of gas wells. This would tend to offset the effects in the relationship of possibly higher acquisition costs for gas acreage.

The record contains a single study which indicates that the cost of lease acquisitions for gas has not exceeded those for oil. In Schedule 7 of his Exhibit 224, Roseman relates the capital accounts for lease investment to the investment in lease and well equipment plus drilling cost for successful wells, classified by lease types. In other words he takes the gross historical investment in lease acquisitions for successful gas aid oil leases, and relates this amount to the corresponding gross historical investment in successful wells and lease equipment. The study shows that lease acquisition investment was 22 percent for gas leases and 20 percent for oil leases. There

is no dispute that lease facility costs on successful oil leases are generally considerably greater than on gas properties. Hence it is probable that if the ratios were limited to the capital accounts for lease acquisition and successful wells, excluding the lease facilities, they would show that the ratio for gas leases was the same as or lower than for oil leases. In any event, the study indicates that the ratio of investment in lease acquisitions to total investment for successful leases is not significantly greater for gas than for oil. This study covers productive leaseholds only. The witness concludes that this limitation doesn't affect the comparison. There is no reason to expect that the respective ratios for oil and gas leases would be changed if leaseholds which are acquired and never go into production were to be included.

There is no evidence that recent investment in gas or oil leases would change the above ratios.

While not conclusive, this study indicates that it is a reasonable hypothesis that the ratio of lease acquisition costs to drilling costs is not significantly different for gas than for oil leases.

It is concluded that Roseman's estimate based on the Chase-Census ratio furnishes the most reasonable estimate for lease acquisition costs. Applying Roseman's ratio to his drilling costs yields 0.76 cents.

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An analysis of the percentages in the table at the bottom of page 2 of this appendix setting out ratios of lease

acquisition costs to successful well costs indicates additional grounds for supporting the presiding examiner's determination of lease acquisition costs. As the examiner noted, in each year for which JAS percentages are available they correspond closely to the Roseman percentages. In 1955 the two figures were the same; in 1956 the JAS figure was one percentage point higher; in 1959, 1960, and 1961 the JAS figure is higher by two percentage points. For 1957 and 1958 no JAS figures are available but the close correlation of the figures of JAS and Roseman for the years in which data is available would indicate that if JAS figures had been available for 1957 and 1958, they would have been close to the Roseman figures of 20 percent for 1957 and 23 percent for 1958. This would indicate than an average of the available JAS figures would be misleading and that a more representative average could be obtained by including figures for 1957 and 1958, based on the observed relationship to Roseman's figures. With this adjustment, the average of the JAS figures would be 28.5 percent, as compared with the 33 percent which is the average of JAS figures actually available. It seems clear therefore that the Roseman figures of 26.4 are not too low and we agree with the examiner that they should be accepted for the purpose of computing the lease acquisition cost.

APPENDIX C, Docket Nos. AR61-1, *et al.*

DETAILED ISSUES IN COMPUTING THE COST OF OLD GAS WELL GAS

In this appendix we shall discuss in more detail several of the issues raised in connection with the historical cost of service determination of the cost for flowing gas at pages 78-89.

Gas-Well Gas Produced from Combination Leases

Basic to the determination of production costs for old gas-well gas is the question of which lease categories should be included in the determination of such costs. There is no controversy over the inclusion of leases covering dry gas as well as gas condensate with and without lease separation. An issue has been raised, however, with respect to the inclusion of the so-called "combination lease", a term used to classify leases producing, or capable of producing, from both oil and gas reservoirs.

In computing its composite cost of gas-well gas, the Staff included data relating to gas-well gas from the combination leases for both production costs and for its E&D allowance. The producers concur in Staff's method insofar as it relates to E&D but contend that data from combination leases should be excluded from consideration in the production expenses and investment costs of gas-well gas because they involve unnecessary and unreliable additional allocations. The examiner pointed out that large amounts of gas-well gas are produced from the

combination leases and that there are economies of joint operation which should be reflected in the costs.

Our decision to base the price of flowing gas upon the cost of gas-well gas was based in part on an effort to minimize the number and complexity of the necessary allocations. Furthermore, because the liquids represent a much smaller portion of the total in gas-well gas than in oil-well gas,

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such a cost is less dependent on allocations and more nearly represents an objective cost for the gas. With this in mind we must observe that to compute the corresponding production expenses and investment costs attributable to gas-well gas on the combination leases will require two distinct stages of allocations. The first stage is to divide the combination lease costs between all gas and all liquids by the use of the relative cost method. This must be done for all gas-well gas. However, there must then be a further breakdown of the costs assigned to gas between dry gas, condensate gas, with and without lease separation, and casinghead gas. This is a complex process, involving allocation formulas which are necessarily subject to dispute. Only when this step is taken can costs related to gas-well gas from combination leases be computed. If combination leases are excluded from the compilation of production costs the more complex two-stage allocation is avoided.

To utilize the costs of combination leases in determining production costs would involve the additional allocations which we believed should be avoided and would

thus defeat a major purpose of limiting the cost to non-associated gas. There is nothing in the record to support the examiner's suggestion that somehow gas-well gas can be produced more economically on a combination lease. We believe the production expense and investment data for gas-well leases which cover some two-thirds of the gas-well gas produced in the area is fully representative of the costs for gas-well gas. Accordingly, combination leases will be excluded from the production cost computation of gas-well gas.

The use of combination leases in the computation of E&D, however, presents no further allocation problem. There are no E&D expenses directly associated with the combination leases. All that is needed to make the E&D computation are the volumes of liquid and gas produced from each type of well, and such volumes are available. Accordingly, we find that the data from the combination leases should be included in the calculation of E&D, which is consistent with the positions taken by both staff and respondents.

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Allocation of Overheads

In addition to the costs directly associated with the producing leases there are certain costs which are incurred in connection with the producers' overall activities. These are corporate general costs and expenses, area and district costs and expenses, prepaid taxes and insurance, corporate general net investment, area and district net investment, and materials and supplies. Such overheads must first be allocated between operating functions (such

as production and E&D), then between lease types, and finally between the gas and liquid products. There is no controversy about the allocation between operating functions, which was performed in most instances by the reporting companies themselves. The specific issue concerning these overhead expenses is the allocation of such costs between the various types of leases.

The Staff allocated these overhead expenses to leases on the basis of direct lease costs and expenses, exclusive of DD&A (depreciation, depletion and amortization) for items which are expensed, and on the basis of relative gross investment in the leases for capital items and the materials and supplies. On the other hand the Major Producer Group would add DD&A to the direct lease cost and expenses as a basis for allocating the common, or overhead, expenses and would use net investment in the leases as the basis for allocating capital items and the materials and supplies.

The examiner adopted staff's methods of allocation, and we affirm the examiner's finding. First, as to the issue whether the overhead expenses should be spread over all of the direct expenses including DD&A, it is clear that they should not. Overhead expenses are largely supervisory expenses and have no bearing on DD&A, which are bookkeeping entries to reflect the use of the investment. They should be allocated on the basis of direct expenses being supervised, which are exclusive of DD&A.

The second question is whether to use gross or net investment as the basis for allocating capital items and materials and supplies, two of the items in the overhead

category. In allocating the common investment items, gross investment more closely reflects management supervision than net investment which is affected by the amount of gas or oil already produced. The same is true for materials and supplies because such expenses continue regardless of whether the investment has been reduced by depreciation and depletion. We shall, therefore, allocate these two items on the basis of gross investment.

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Reinjected Volumes

An important question relating to the volumes used in computing the cost of flowing gas is the treatment of gas that is produced from the well, but is reinjected for the purpose of improving operating efficiency and increasing the recovery of liquids. If the reinjected volumes are included the effect is to reduce the unit cost of gas sold below what it would have been if costs were applied only to volumes sold, and the volumes produced but reinjected were disregarded. This is true because the same costs would be spread over a greater volume.

Respondents maintain that reinjection operations relate only to cash production expenses, and that except for these expenses all other costs should be computed on the basis of the volumes sold, which would be a smaller volume (and at higher cost) than if the total volume produced including the volumes subsequently reinjected were used. On the other hand staff maintains that all costs — cash productions cost, DD&A, return on investment

and exploration costs — should be applied to total volumes produced regardless of their disposition.

The use of total production volume, rather than sales volume, in computing the cost per Mcf assures that the share of total production costs related to the liquids derived from reinjected gas are in fact borne by liquids. For example, costs of recycling include investment in reinjection wells and other equipment, which should be borne by the liquids. In our opinion the use of production volumes, an approach which was adopted by the examiner, is the proper one. The cost of obtaining the liquids is not confined to the current expense of lifting, processing, and reinjecting the gas; all the other expenses, such as production investment and the like, are necessary as well. If they were not incurred, there would be no gas to recycle for the benefit of the liquids.

The conclusion is in accord with our prior decision on this issue in *H. L. Hunt, et al.*, 28 FPC 897 (1962). In that case the Commission stated that production volumes rather than sales volumes should be used in cost computation, and specifically mentioned recycled gas as included in production volumes.

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* * * For example gas that is recycled, gas used for off-lease purposes, gas used by other departments in drilling or production, and gas shifted to company gathering systems or plants all represent situations in which substantial volumes of gas may have been produced but would not be included in sales volumes.

> The overstatement of the unit cost of single product gas inherent in the use of sales volumes also distorts the allocation of joint product costs. For example it is obvious that under the relative cost method too much of the joint production costs will be allocated to gas if the production cost of gas-well gas has been overstated. [.902]

Application of Relative Cost Method

A. *General Approach*

As a preliminary matter we are confronted with a dispute over methodology. Phillips' Witness Cramer presented a variant of the relative cost method which has been referred to as the "Y" Ratio method. The relative cost method relies on an allocation ratio based on single product costs, but the "Y" Ratio method includes in its base the costs and production of joint products, which are the very costs to be allocated by the ratio to be derived.

The "Y" Ratio method requires the use of a cubic equation and results in a mathematical formulation that is solved with a computer. Complicated formulas, even mathematical ones, do not necessarily produce meaningful results. We are persuaded that the method proposed by Witness Cramer creates only an illusion of precision and is less meaningful than the relative cost method of allocation. Under these circumstances we agree with the examiner that no reason has been shown to adopt this method.

In applying the relative-cost method there are three detailed issues on which staff and the producer-respondents differ. One is whether gas condensate leases should be included in the gas leg, a second is whether shut-in

leases should be included in the oil and gas legs, and the third is whether the joint products should be allocated on the basis of gross investment rather than on the basis of net investment.

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B. *Gas Condensate Leases*

The Staff in deriving a gas leg added to the dry gas leases, the gas-condensate leases without lease separation but excluded the gas-condensate where lease separation occurred. Respondents argue that all condensate gas, both where lease separation took place and where it did not, should be included in the gas leg. In support of their position respondents urge that there is no difference from an operating and well investment standpoint between gas condensate leases and the dry gas leases which were included, and that all the gas condensate leases should be included to reflect representative conditions relating to production on joint product leases, because otherwise the gas leg is too small to be representative.

Essentially the respondents argue that all gas condensate production should be included in the gas leg because gas condensate and dry gas leases are similar. Their argument misses the point. Obviously if there is sufficient dry gas to provide a representative gas leg, no gas condensate at all should be added. If not, the issue is the extent to which gas-condensate lease types need be added to achieve representative conditions.

Producers responding to the Commission questionnaire for the major producers (Appendix B) produced

41,652,569 Mcf of dry gas in the Permian Basin in 1960, about 4 percent of their total gas production in that area. In computing the Permian Basin gas leg of such producers, staff added to this dry gas production 1,271,495 Mcf of gas-condensate gas produced by them from leases without lease separation.

In the past, in cases dealing with individual companies, the Commission has considered that a dry gas leg representing as little as 4 percent of the total gas production of a company was an inadequate sample, and has indicated that there should be added to the gas leg a portion of the gas condensate production for the purpose of obtaining a larger sample. *H. L. Hunt, et al., supra; Hunt Oil Company, et al., supra; Union Producing Co., et al., supra.* In none of these cases, however, did the amount of dry gas production approach

the 41,652,569 Mcf of dry gas which would be the sample here if the gas leg were restricted to dry gas. Also, in the three cases cited, we were dealing with the nationwide production of individual companies and the only practicable method of enlarging the sample was to depart from a strictly single product leg and include a portion of the company's gas condensate production. In the present proceeding, however, if it were determined that the 41,652,569 Mcf of dry gas produced by the major producers in the Permian Basin were an inadequate sample it would still be possible to maintain an all dry gas leg by using the national production of dry gas by the same

companies. Although the nationwide production of dry gas by these companies is only approximately 13 percent of their total gas production, it amounts to 862,395,237 Mcf annually, a production several times larger than all of that used in computing the gas leg in *Phillips Petroleum Company, supra,* (226,681,178 Mcf). There is no question that the 862,395,237 Mcf is a sufficient volume for an adequate sample.

The total costs allocated to gas by the relative cost method vary only in a negligible amount, whether national production or Permian Basin production of dry gas is used as the sample. The Staff's inclusion of gas condensate without lease separation also has little effect. The computations of production costs are as follows:

Type of gas leg used	Gas-well gas Costs in Cents per Mcf (at 12% rate of return)
Nationwide Dry Gas Production[1]	9.136
Permian Basin Dry Gas Production	9.157
Permian Basin Dry Gas + Gas Condensate Without Lease Separation	9.161

[1] This computation has been made using Permian Basin cost data but applying an allocation ratio derived from national statistics. We reassert that for flowing gas the area costs are to be used in computing production costs. The use of the national dry gas volumes would be for the sole purpose of developing allocation ratios.

It will be noted that the costs, as computed on the basis of an allocation ratio derived from national production, differ by approximately .02 cent per Mcf from the compu-

tation of such costs derived from the ratio of dry gas production in the Permian Basin, and that the ratio derived from Permian Basin production is more favorable to the producer-respondents. The computation actually used by the Staff, which included gas condensate without lease separation in determining the allocation ratio, varies from the determination made on the basis of the Permian dry gas only by approximately .004 cent, and, again, the miniscule difference is favorable to the producer-respondents.

We think that if there is an insufficient area dry gas leg the use of national dry gas production would be preferable to the inclusion of gas condensate production for the purpose of determining the allocation ratio. However, where an area gas leg is derived from dry gas volumes of 41,652,569 and where the use of national dry gas production would produce a result equivalent to use of the area dry gas production, we believe it is proper to use the area production leg. Since the inclusion in the gas leg of the small amount of gas condensate by staff resulted in such an insignificant difference in cost, for the purposes of this case we will adopt Staff's computation. Regardless of which of these two computations we choose, it would not alter the cost sufficiently to affect the price of old gas-well gas as herein determined.

C. *Shut-in Leases*

Staff in computing its gas leg and oil leg excluded shut-in leases for purposes of determining the allocation percentages, although the actual cost of the shut-in leases in the joint lease category is, of course, included in the

joint cost when the allocations are applied. Respondent-producers contend that shut-in leases should be included in determining the allocation percentages, because they are part of the cost of producing gas and shut-in oil leases are part of the cost of producing oil. The issue has been previously determined by this Commission. "Non-producing properties should not be included in ascertaining the oil and gas legs for allocation of the joint production costs." *Hunt Oil Co., et al.*, 28 FPC 623, 624 (1962). Shut-in lease costs are not representative of the production costs of either gas wells or oil wells because they are essentially non-producers. Their inclusion in the oil and gas legs would distort an otherwise representative single product cost factor and thus defeat the underlying principle behind the relative cost allocation method.

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D. *Gross or Net Investment*

In computing the gas leg and oil leg for determining the relative cost of the joint production, the separate costs of each product must include an element of return on investment. Rather than using net investment, Staff would allocate the return allowance on the joint production on the basis of gross investment in leases producing separate single products. Respondents would use net investment. They argue that the use of gross investment overlooks the fact that this particular use of the relative cost theory is applied to production investment for the sole purpose of computing a return on investment, and

that such return is computed on net investment, not gross investment.

The fact that the purpose of the allocation is to compute a return on investment is irrelevant, the test being which method more nearly reflects the operating facts of the joint production. The basic fact which raises the issue between gross and net investment is that oil-only leases are generally more depleted than dry gas leases.[2] Thus, using net investment would tend to assign less cost to oil and more to gas than if gross investment is used. On joint product leases (except some combination leases), the depletion rate is the same for liquids as for gas. Allocation on the basis of the gross investment more nearly reflects that fact. If net investment is used as the basis for the allocation it would impose a comparatively greater burden on gas than oil because of the relatively lower net investment of the oil-only leases which are more depleted. Its use would not reflect the true state of affairs on many joint product leases. We shall, therefore, use gross investment for this allocation.

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Lease Play Allowance

In our calculation of working capital for new gas, we included an additional allowance for lease play over and above the working capital allowance which would be

[2] Oil leases average 62 percent depletion, nationally, and 55 percent in the Permian Basin, contrasted with an average depletion for dry gas leases of 40 percent nationally and 37 percent in the Permian Basin.

justified under the traditional utility method.[3] The question arises as to whether this additional allowance should be permitted in the cost computation for flowing gas. In *Hunt Oil Company*, 28 FPC 623 (1962) and in *Union Producing Company*, 31 FPC 41 (1963) the Commission denied lease play allowances on the ground that since a year-end rate base was being utilized such an allowance was unwarranted. The rationale for this finding was that any money expended to obtain leases during the year would receive a full year's return, even though such properties may have been purchased late in the year. These cases were not precedents for excluding a lease play allowance under our new gas calculation since an average-year rate base and not a year-end rate base was being used. However, in the development of our composite cost of service for flowing gas, we are using a year-end rate base. Accordingly, in view of the findings made in the *Union Producing* and *Hunt* cases no additional allowance for lease plays is included in the cost calculation for flowing gas.

[3] In our computation of the new gas cost, there is a separate classification for working capital. In the development of a composite cost of service the working capital allowance is not set out separately but is combined with investment in property under the separate cost computation for production cost and E&D cost.

Computation of E&D Allowance

The Commission utilized the modified Btu method in allocating E&D costs. In its application of this method the Commission used an economic factor of 3.5 for lease liquids and 1.0 for all gas. The E&D costs related to the Appendix "B" respondents are set out on the following page of this appendix. The results are summarized below.

E&D Allocated to Gas-Well Gas

	Cost (Return at 12%)	Unit Cost (Return at 12%)
		¢ per Mcf
Expense	$167,036,961	3.46¢
Return[4]	30,010,322	0.62
	$197,047,283	4.08¢

[4] In the costing of old gas, certain costs classified as E&D costs are "capitalized" and made part of an E&D rate base, while certain items are "expensed." In deriving the cost of new gas, no items except "expensed" items were classified as E&D, and, therefore, no separate E&D rate base was developed. All new gas cost items which were capitalized, regardless of whether they were applicable to E&D or production, were put into the production investment rate base. This distinction between old and new gas is one of accounting classification. The final cost computation under either method is not affected by this difference.

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Allocation of Appendix "F" Recomputed's F & D Costs Using Economic Factors Of 3.5 For Liquids and 1.0 For All Gas

(1)	Volumes 1/ Liquids (Bbl.) (2)	Volumes 1/ Gas (Mcf) (3)	Unit Rate 1/ (Millions Per Bbl or Mcf) (4)	Total Dist'd 1/ (Million Dlrs) (5)	Economic Factor (6)	Adjusted Basis (Million Dlrs) (7)	Allocated Expense Amount 2/ (8)	Allocated Expense Unit (¢/Bbl or Mcf) (9)	Allocated Return Allowance Amount 2/ (10)	Allocated Return Allowance Unit (¢/Bbl or Mcf) (11)	Allocated Expense & Return Allowance Amount (12)	Allocated Expense & Return Allowance Unit (¢/Bbl or Mcf) (13)
Net Working Interest												
Oil Only Leases												
Lease Liquids	388,551,303	—	5.872	1,899,251,251	3.5	6,752,386,378	214,390,638	55.253	38,518,614	11.724	252,908,652	76.977
Raw Gas	—	36,330,306	1.233	44,795,144	1	44,795,144	1,422,248	3.915	255,527	0.703	1,677,769	4.618
Oil Casinghead Gas Leases												
Lease Liquids	689,970,938	—	5.811	4,009,117,139	3.5	14,032,960,487	445,551,429	64.575	80,068,999	11.602	525,600,428	76.177
Raw Gas	—	1,330,373,895	1.272	1,698,235,594	1	1,698,235,594	53,929,014	4.039	9,693,114	0.726	63,582,128	4.765
Gas Only Leases												
Lease Liquids	48,680	—	5.426	263,968	3.5	923,888	29,334	60.296	5,270	10.832	34,604	71.128
Raw Gas	—	862,395,237	1.042	898,835,837	1	898,835,837	28,537,368	3.308	5,126,068	0.594	33,663,396	3.903
Gas-Condensate Lease Separation Leases												
Lease Liquids	44,298,184	—	5.412	239,764,539	3.5	837,775,886	26,599,679	60.142	4,778,972	10.805	31,378,652	70.947
Raw Gas	—	2,378,113,786	1.089	2,589,220,608	1	2,589,220,608	82,208,668	3.457	14,769,834	0.621	96,978,502	4.078
Gas-Condensate No Lease Separation Leases												
Lease Liquids	2,501,136	—	5.053	12,639,463	3.5	44,238,121	1,404,576	56.158	252,350	10.089	1,656,926	66.247
Raw Gas	—	568,137,588	1.168	667,815,435	1	667,815,435	20,582,017	3.625	3,694,229	0.655	24,276,246	4.280
Combination Leases												
Lease Liquids	158,252,958	—	5.771	1,121,075,653	3.5	3,923,764,785	124,580,910	68.133	22,382,550	11.522	146,963,460	75.655
Raw Gas Produced From Oil Wells	—	532,497,771	1.187	632,312,278	1	632,312,278	20,076,137	3.769	3,605,934	0.677	23,683,071	4.446
Raw Gas Produced From Gas Wells	—	147,813,158	1.092	161,348,155	1	161,348,155	5,120,184	3.464	919,908	0.622	6,040,092	4.086
Raw Gas Produced From Gas-Cond. Wells	—	876,996,057	1.102	966,732,302	1	966,732,302	30,691,718	3.499	5,512,355	0.629	36,204,073	4.128
Sub-Total, Raw Gas, Combination Leas.	—	1,555,306,986	1.130	1,757,392,735	1	1,757,392,735	55,888,039	3.594	10,038,197	0.645	65,926,236	4.239
Sub-Total, NGL, Lease Liquids	1,259,555,109	—	5.805	7,312,028,213	3.5	25,592,069,745	813,556,566	64.611	146,086,195	11.599	959,642,761	76.210
Raw Gas	—	6,786,845,718	1.134	7,630,291,482	1	7,630,291,482	242,548,458	3.578	43,525,897	0.642	286,074,355	4.220
Casinghead Gasoline, Lease Liquids	22,522,452	—	5.835	130,748,135	3.5	457,618,473	14,549,647	64.611	2,610,418	11.590	17,159,985	76.201
Raw Gas	—	180,395,367	1.115	201,509,849	1	201,509,849	6,405,959	3.552	1,166,597	0.647	7,659,856	4.249
Total, Lease Liquids	1,282,077,560	—	5.805	7,442,776,348	3.5	26,049,688,218	827,806,213	64.611	148,696,613	11.599	976,802,686	76.210
Raw Gas	—	6,967,241,085	1.134	7,831,801,331	1	7,831,801,331	248,954,417	3.578	44,692,494	0.642	293,646,911	4.220
	1,282,077,560	6,967,241,085		15,274,577,679		33,881,489,549	1,076,760,630		193,389,107		1,270,449,597	
Appendix "F" Gas-Well Gas Computation 3/		1,817,163,816					167,026,481	3.460	29,010,372	0.602	197,047,853	4.082

1/ Volumes and Dist'n obtained from Exhibit No. 170, Schedule Nos. 8(A) and 9(A).
2/ Total Distributed on basis of adjusted Basis in Column (7).
3/ Total Expense data obtained from Exhibit No. 168, Schedule No. 7.
4/ Return Allowance data obtained from Exhibit No. 168, Schedule No. 6, Line 33 times 12%.
5/ Summary of Gas-Well Gas Costs as computed by combining applicable costs related to Gas Only Leases, Gas Condensate with Lease Separation Leases, Gas Condensate No Lease Separation Leases, and Combination Leases.

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RATE SCHEDULE - QUALITY STATEMENT

1. APPLICABLE SECTION 4(e) DOCKET NO(S). (If any) (Use space below if needed)

2. PRODUCER NAME

3. RATE SCHEDULE NO.

4. TYPE OF GAS (Check one)

A. ☐ NEW GAS-WELL GAS
B. ☐ RESIDUE GAS DERIVED FROM NEW GAS-WELL GAS
C. ☐ RESIDUE GAS NOT DERIVED FROM NEW GAS-WELL GAS
D. ☐ OLD GAS-WELL GAS
E. ☐ CASINGHEAD GAS
F. ☐ MIXED GAS (Give proportion of types A and B) _____

5. PLACE OF PRODUCTION (Give State, County, Field and Municipality)

6. QUALITY OF GAS	PRODUCER'S STATEMENT OF QUALITY AND TREATING COSTS		BUYER'S STATEMENT OF QUALITY AND TREATING COSTS (If same as producer, indicate by check mark)	
	CONTENT OR PRESSURE	COST PER MCF OF TREATING GAS TO PIPELINE STANDARDS	CONTENT OR PRESSURE	COST PER MCF OF TREATING GAS TO PIPELINE STANDARDS
A. HYDROGEN SULPHIDE CONTENT (In grains per Mcf)...				
B. TOTAL SULPHUR CONTENT (In grains per Mcf).....				
C. CO_2 CONTENT (Percentage of volume sold).....				
D. H_2O CONTENT (In pounds per Mcf).....				
E. CONTENT OF OTHER IMPURITIES (Indicate whether above or below customary commercial and pipeline standards).....				
F. ACTUAL DELIVERY PRESSURE (Pounds per square inch)				
G. TOTAL				
H. BTU CONTENT PER MCF (New gas well gas only).....				

7. APPLICABLE AREA CEILING RATE _____ cents per Mcf

8. BTU PRICE ADJUSTMENT * (State whether plus or minus) _____ cents per Mcf

9. APPLICABLE RATE (Ceiling rate less treating costs, with Btu adjustments if any *) _____ cents per Mcf

10. RATE HERE ESTABLISHED (Not above applicable ceiling rate as adjusted) _____ cents per Mcf

NOTHING HEREIN SHALL PREVENT THE SELLER FROM FILING FOR ANY INCREASED RATE PERMITTED BOTH BY THE CONTRACT (IN THE ABSENCE OF THIS STATEMENT) AND BY APPLICABLE ORDER OF THE FEDERAL POWER COMMISSION.

12. SIGNATURE OF SELLER, AGENT OR OPERATOR

11. DATE OF STATEMENT

13. SIGNATURE OF BUYER

NOTE:
THE TERMS HEREIN ARE THOSE USED IN THE OPINION OF THE FEDERAL POWER COMMISSION IN PERMIAN BASIN AREA RATE PROCEEDING, AR61-1. NEW GAS-WELL GAS IS NATURAL GAS DERIVED FROM GAS WELLS MOVING UNDER CONTRACTS DATED ON OR AFTER JANUARY 1, 1961. THE BURDEN IS UPON A PRODUCER TO ESTABLISH THAT PARTICULAR GAS IS NEW GAS-WELL GAS OR RESIDUE GAS DERIVED THEREFROM, AND ALSO TO ESTABLISH THE PERCENTAGE OF SUCH GAS PRESENT IN A SALE OF MIXED GAS.

* Btu price adjustment to be applied in case of new gas well gas only.

APPLICATION FOR SMALL PRODUCER CERTIFICATE OF PUBLIC CONVENIENCE AND NECESSITY

(Section 157.40 of Regulations)

NOTE: Independent Producers of natural gas whose total jurisdictional sales on a nationwide basis for the preceding year, combined with those of " affiliated producers, " were not in excess of 10,000,000 Mcf may file the information called for in the following forms(In four copies, to the Federal Power Commission, Washington D.C.,20426.) Include volume of gas paid for but not taken under prepayment clauses or otherwise, and volumes of gas sold under other independent producer rate schedules in the proportion that the independent producer seeking to come with Section 157.40 has an interest in such sales. Do not include sales made pursuant to percentage sales contracts. If insufficient space is given for a complete answer, continue the answer on the reverse side, noting the relevant number.

1. NAME OF APPLICANT

2. STATE OF ORGANIZATION

3. LOCATION OF PRINCIPAL PLACE OF BUSINESS

4. TYPE OF ORGANIZATION (Corporation, partnership, joint venture, etc)

5. NAMES OF STATES IN WHICH AUTHORIZED TO DO BUSINESS

6. NAME, TITLE AND MAILING ADDRESS OF PERSON RESPONSIBLE FOR APPLICATION

NAME AND TITLE

MAILING ADDRESS

7. TOTAL JURISDICTIONAL SALES VOLUMES AT _____ PSIA FOR PRECEDING YEAR

8. LIST ALL CERTIFICATES PRESENTLY HELD BY DOCKET NUMBER AND ALL CONTRACTS ON FILE WITH THE COMMISSION AS RATE SCHEDULES BY RATE SCHEDULE NAME AND NUMBER

9. IF APPLICANT DOES NOT HAVE ANY OUTSTANDING CERTIFICATES ISSUED BY THE COMMISSION FOR THE SALE OF GAS, LIST FOR EACH JURISDICTIONAL SALE OR TRANSPORTATION CONTRACT: (A) NAME OF PURCHASER; (B) SOURCES OF PRODUCTION BY STATE, COUNTY AND FIELD; (C) ANNUAL CONTRACT VOLUME DELIVERY OBLIGATION (Indicate psia per Mcf); (D) TOTAL PRICE PER MCF AT TIME OF FILING

10. LIST ALL OWNERS OF MORE THAN 5 PERCENT INTEREST IN APPLICANT: (A) INDIVIDUAL NAME; (B) PERCENT OF OWNERSHIP

11. LIST ALL INTEREST OWNED BY THE INDIVIDUALLY NAMED OWNERS IN OTHER NATURAL GAS COMPANIES: (A) INDIVIDUAL NAME; (B) COMPANY NAMES; (C) PERCENT OF OWNERSHIP

12. LIST ANY POSITIONS HELD BY THESE INDIVIDUAL OWNERS IN APPLICANT COMPANY OR ANY OTHER NATURAL GAS COMPANY

13. IS APPLICANT OR ANY INDIVIDUAL OWNER LISTED, AFFILIATED WITH ANY PURCHASER OF JURISDICTIONAL GAS FROM APPLICANT (If so list name of buyer and seller for each such sale and nature of affiliation)

14. LIST ALL OWNERS OF MORE THAN 1/8TH INTEREST IN EACH GAS SALE CONTRACT TO BE COVERED BY THIS CERTIFICATE AND THE AMOUNT OF THEIR INTEREST.

SIGNATURE	TITLE	DATE

(Use reverse side for additional comments and identify)

277,801

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Before Commissioners: Joseph C. Swidler, Chairman;
Lawrence J. O'Connor, Jr.,
Charles R. Ross;
David S. Black;
Carl E. Bagge

	Docket Nos.
Area Rate Proceeding	AR61-1, *et al.*
North Central Oil Corporation (Operator), *et al.*	CI60-435
Socony Mobil Oil Company, Inc.	CI61-34
Robert T. Brown (Operator), *et al.*	CI61-733
Texaco Inc.	CI61-879

ORDER ISSUING CERTIFICATES
(Issued August 5, 1965)

By Opinion No. 468 and order in this proceeding issued concurrently with this order we have prescribed the just and reasonable rates for jurisdictional sales of natural gas in the Permian Basin area. There are four applications for certificates of public convenience and necessity which were consolidated in this proceeding and these are the subject of the present order. Temporary certificates have been granted to all four applicants and the gas is now flowing in interstate commerce.

The only issue presented by the applications is the initial price at which the gas is to be certificated. As we stated in Opinion No. 468, the just and reasonable area rate fixed therein constitutes the "in line" price required

by the public convenience and necessity in granting permanent certificates. All of the applications involve "flowing gas" as defined in Opinion No. 468, produced in Texas. The applicable area rate is 14.5 cents per Mcf at 14.65 psia adjusted to reflect any quality deficiencies in the gas and we shall therefore grant the certificates conditioned to an initial price no higher than the applicable area rates. The certificates shall be subject to the moratorium on any rate increase filing in excess of the applicable area rate prior to January 1, 1968, as provided in Opinion No. 468, pp. 107-113.

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Each of the certificate applications has a somewhat different history from the others and also differs in its contract provisions. We shall therefore discuss each of them separately.

The proposed rate schedule of *North Central Oil Company* (Operator), *et al.*, Docket No. CI60-435, contains provisions specifying that the gas must equal or exceed in every particular the pipeline quality standards established in Opinion No. 468. A permanent certificate will therefore be issued in this docket providing for an initial price of 14.5 cents per Mcf at 14.65 psia. The temporary certificate contained no refund condition but a rate increase was filed during the period of the temporary. The increased rate was suspended pursuant to Section 4(e) and has subsequently been collected subject to refund, Docket No. RI65-288. The last-mentioned docket has not been consolidated herein and accordingly the question of refunds in that proceeding will be disposed of

pursuant to the Order to Show Cause issued this date. The question of whether refunds should be ordered during the period of the temporary when no express refund obligation was operative, but prior to the effective date of the proposed increased rate, will be deferred until our decision of the same issue in Skelly[1] and Amerada[2].

Robert T. Brown (Operator), et al., Docket No. CI61-733 involves sales made under a temporary certificate without an express refund condition. The related contract contains provisions requiring gas moving under it to equal or exceed pipeline quality standards in all respects save for hydrogen sulphide and total sulphur. The permanent

certificate will provide for an initial price computed by modifying the ceiling price of 14.5 cents per Mcf by deducting therefrom the cost of processing the gas to meet the pipeline quality standards for the Permian Basin. Accordingly the producer (unless these sales qualify as small producer sales as defined in the rule proposed this date providing for small producer certificates for such sales) shall, within 90 days of the effective date of this order, file a statement which shall state either that the gas accords with all pipeline quality standards established in Opinion No. 468 or in which respects the gas deviates from such standards, the agreed cost to the buyer of processing the gas to bring it to the quality standards with

[1] Skelly Oil Company, Docket Nos. G-18638, *et al.*

[2] Amerada Petroleum Corporation, *et al.*, Docket Nos. CI62-1544, *et al.*

respect to each quality defect, and the resulting rate for the gas. Such statement shall be signed by both seller and buyer. However, if the seller and buyer are unable to agree upon any or all of the particulars entering into the computation of the proper price, the seller must so indicate in the statement and supply the information required to compute the applicable area rate as adjusted as well as the contentions of the parties with respect to the quality and amount of the adjustment as any item in dispute. The buyer may file a separate statement setting forth its views within such period. In such event the Commission will then determine the amount of the quality deduction. As in the case of *North Central Oil Corporation (Operator) et al., supra,* the determination of any refunds which may be due for the period of the temporary, when no express refund conditions were in effect, shall be deferred.

The applications of *Socony Mobil Oil Company, Inc.,* (Socony), Docket No. CI61-34, and *Texaco Inc.,* Docket No. CI61-879, involve so-called Spraberry or El Paso contracts. In accordance with the principles established in Opinion No. 468, the applicable area rate will be applied to the volumes of residue gas taken into the purchaser's pipeline under these contracts. The contracts provide that there shall be a reduction in the price paid for such residue gas if treatment of the casinghead stream received by the buyer is necessary to remove sulphur. The cost of such treatment and the cost of any other necessary treatment of the casinghead stream to bring the gas to pipeline quality, aside from those processing costs incurred in removing the liquids, must be deducted

from the ceiling price of 14.5 cents per Mcf to determine the applicable area rate. The certificates granted in these two dockets will be conditioned upon a filing by the producer within 90 days of the effective date of this order of a statement as to quality of the casinghead gas and cost

of treating (or an estimate if no agreement is reached) as described above and further conditioned upon an initial price equal to the applicable rate established by deduction from 14.5 cents per Mcf of the cost of treating the gas to pipeline quality standards as such cost is determined by agreement of the parties or by the Commission. During the time they were operating under these temporary certificates both Socony and Texaco Inc. filed for rate increases which were suspended and are now in effect subject to refund. Computations of the refunds due for the period during which these rates have been collected subject to refund will be dealt with in the Section 4(e) proceedings—Docket Nos. RI65-209 and RI65-115.

Socony succeeded to a temporary certificate which contained a refund condition. Texaco Inc. succeeded to a temporary certificate without refund condition. Accordingly, Socony will be required to submit a computation of all excess amounts collected for the entire period of operations under the temporary certificate except the time during which the Section 4(e) proceeding was pending, and to make refund of those amounts with interest. For the reasons previously stated, Texaco Inc. will not be required at this time to make any refunds for the period when there was no express refund condition.

All certificates issued herein shall be subject to a moratorium against rate increases prior to January 1, 1968, unless such increases are authorized by later order of the Commission.

The Commission finds:

(1) Each applicant for a certificate of public convenience and necessity listed in Appendix A hereto is a natural-gas company within the meaning of the Natural Gas Act as an independent producer of natural gas, as that term is defined in section 154.91(a) of the Commission's Regulations, engaged in the sale of natural gas in interstate commerce for resale for ultimate public consumption and such sales together with the construction and operation of any facilities therefor are subject to the requirements of subsections (c) and (e) of Section 7 of the Natural Gas Act.

(2) Each applicant listed in Appendix A hereto is able and willing properly to do the acts and to perform the services proposed and to conform to the provisions of the Natural Gas Act and the requirements, rules and regulations of the Commission thereunder.

(3) The sale of natural gas as proposed herein by each applicant listed in Appendix A hereto together with the construction and operation of any facilities subject to the jurisdiction of the Commission necessary therefor are required by the public convenience and necessity and a certificate authorizing the same should issue to each of them upon the terms and conditions of the order herein,

which terms and conditions are required by the public convenience and necessity.

(4) Except as granted in the order in Opinion No. 468 the exceptions of the applicants listed in Appendix A hereto to the presiding examiner's initial decision and proposed order should be denied.

The Commission orders:

(A) Certificates of public convenience and necessity are issued, upon the terms and conditions of this order, authorizing the sales by the applicants listed in Appendix A to this opinion of natural gas in interstate commerce for resale, together with the construction and operation of any facilities subject to the jurisdiction of the Commission necessary for such sales, all as hereinbefore described and as more fully described in the respective applications, amendments, supplements and exhibits in this proceeding.

(B) The certificates granted in paragraph (A) above are not transferable and shall be effective only so long as the applicants continue the acts or operations hereby authorized in accordance with the provisions of the Natural Gas Act and the applicable rules, regulations and orders of the Commission.

(C) The grant of the certificates issued in paragraph (A) above shall not be construed as a waiver of the requirements of Section 4 of the Natural Gas Act or Part 154 or Part 157 of the Commission's Regulations thereunder, and

is without prejudice to any findings or orders which have been or may hereafter be made by the Commission in any proceeding now pending or hereafter instituted by or against the respective applicants. Further, our action in this proceeding shall not foreclose or prejudice any future proceedings or objections relating to the operation of any price or related provisions in the gas purchase contracts herein involved. The grant of the certificates aforesaid for service to the particular customers involved shall not imply approval of all the terms of the respective contracts, particularly as to the cessation of service upon termination of said contracts, as provided by Section 7(b) of the Natural Gas Act. The grant of the certificates aforesaid shall not be construed to preclude the imposition of any sanctions pursuant to the provisions of the Natural Gas Act for the unauthorized commencement of any sales of natural gas subject to said certificates.

(D) The notice provisions of Section 154.94(b) and the detailed submittal subprovisions of Section 154.94(f) of the Commission's Regulations Under the Natural Gas Act are waived insofar as they apply to any reductions in rates hereby ordered.

(E) The certificate granted to North Central Oil Corporation (Operator), *et al.*, is conditioned upon a total initial price, including tax reimbursement, of 14.5 cents per Mcf at 14.65 psia, and within 30 days of the effective date of this order North Central shall file a supplement to its presently filed rate schedule reflecting the con-

ditioned price as the initial price in lieu of the initial price provided in the present rate schedule.

(F) The certificates granted to the applicants, other than North Central Oil Corporation (Operator), *et al.*, are hereby conditioned to a total initial price, including tax reimbursement, no greater than the applicable base area rate of 14.5 cents per Mcf at 14.65 psia subject to further reductions, effective as of the effective date of this order, for any quality deviations as determined pursuant to ordering paragraph (G) hereof, and further conditioned upon the filing by the respective applicants within 30 days of the determination of such rate of a supplement to its filed rate schedule reflecting the applicable area rate in lieu of any rate provided in the rate schedule then on file, and further conditioned upon refunds being made with interest by each applicant of the difference between the applicable area rate and any rate in excess thereof collected subsequent to the effective date of this order. The manner and time of such refunds shall be determined by the Commission in a later order.

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(G) The certificate hereby granted to each applicant listed in Appendix A hereto, other than North Central Oil Corporation (Operator) et al., is issued upon the condition that such applicant (unless the sale qualifies as a small producer sale pursuant to the proposed rule issued this date) shall file, within 90 days of the effective date of this order, a statement that the gas accords with all pipeline quality standards established in Opinion No. 468 or in which respects the gas deviates from such standards,

the agreed cost to the buyer of processing the gas to bring it to the quality standards with respect to each quality defect and the resulting rate for the gas. Such statement shall be signed by both seller and buyer. However, if the seller and buyer are unable to agree upon any or all of the particulars entering into the computation of the proper price, the seller must so indicate in the statement and supply the information required to compute the applicable area rate as adjusted as well as the contentions of the parties with respect to the quality and amount of the adjustment as any item in dispute. The buyer may file a separate statement setting forth its views within such period.

(H) The certificate granted to Socony Mobil Oil Company, Inc. is issued upon the condition that the said applicant shall file within 120 days of the effective date of this order a report in triplicate with this Commission of the refunds due each buyer by reason of the collection by said applicant and its predecessor of rates in excess of the applicable area rate during the period in which such excess rates were collected prior to the effective date of the rate which is the subject of the present proceeding in Docket No. RI65-209.

(I) Socony Mobil Oil Company, Inc. shall retain the amounts shown in the report required under (H) above, subject to further order of the Commission directing the disposition of those amounts. If said applicant elects to commingle these retained refunds with its general assets and use them for its corporate purposes, it shall pay

interest thereon at the rate of 7 percent per annum on all funds thus available from the date of the filing of the refund report to the date on which they are paid over to the person ultimately determined to be entitled thereto in a final order of the Commission. If the applicant elects to deposit the retained refunds in a special escrow account, the respondent shall tender for filing on or before the date of the filing of the refund report an executed Escrow Agreement, conditioned as set out below accompanied by certificate showing service of a copy thereof upon each of its jurisdictional customers. Unless notified to the contrary by the Secretary within 30 days from the date of filing thereof, the Escrow Agreement shall be deemed to be satisfactory and to have been accepted for filing. The Escrow Agreement shall be entered into between respondent and any bank or trust company used as a depositor for funds of the United States Government and the agreement shall be conditioned as follows:

(1) Respondent, the bank or trust company, and the successors and assigns of each, shall be held and formally bound unto the Federal Power Commission for the use and benefit of those entitled thereto, with respect to all amounts and the interest thereon deposited in a special escrow account, subject to such Agreement, and such bank or trust company shall be bound to pay over to such person or persons as may be identified and designated by final order of the Commission and in such manner as may be therein specified, all of any portion of such deposits and the interest thereon.

(2) The bank or trust company may invest and re-invest such deposits in any short-term indebtedness of the United States or an agency thereof or in any form of obligation guaranteed by the United States which is, respectively, payable within 120 days as the said bank or trust company in the exercise of its sound discretion may select.

(3) Such bank or trust company shall be liable only for such interest as the invested funds described in Paragraph (2) above will earn and no other interest may be collected from it.

(4) Such bank or trust company shall be entitled to such compensation as is fair, reasonable and customary for its services as such, which compensation shall be paid out of the escrow account to such bank or trust company. Said bank or trust company shall likewise be entitled to reimbursement for its reasonable expenses necessarily incurred in the administration of this escrow account, which reimbursement shall be made out of the escrow account.

(5) Such bank or trust company shall report to the Secretary of this Commission quarterly, certifying the amount deposited in the trust account for the quarterly period.

(J) The decision whether refunds should be ordered as a condition of the permanent certificate of applicants, other than Socony Mobil Oil Company, Inc., listed in Appendix A hereto is deferred for subsequent determination. Such certificates shall issue at the present time subject to the condition that the subsequent determination of the Commission with respect to such refunds shall then be incorporated in each such certificate as a condition thereof.

(K) The certificate granted to each applicant listed in Appendix A hereto is issued upon the condition that the applicant shall not file any change in rate providing for

a price in excess of the applicable area rate prior to (1) subsequent order of the Commission in this proceeding permitting such filing or (2) January 1, 1968, whichever is earlier.

(L) The certificate of each applicant listed in Appendix A is issued upon the condition that the proposed rate schedule of the applicant shall be amended by the inclusion of the following language:

> "From the effective date of the order of the Federal Power Commission in the Permian Basin Area Rate Proceeding AR61-1, until January 1, 1968, no increase in rates may be filed, except in compliance with a specific order of the Commission, at a rate in excess of the applicable area rate as determined pursuant to said proceeding or pursuant to later order of the Commission. Applicable area rate, as that term is used herein, shall mean the rate to be determined after all adjustments from the ceiling price because of deviations from the pipeline quality standards established in the aforesaid order of the Commission."

(M) Except as herein granted the exceptions to the initial decision and proposed order are hereby denied.

By the Commission.

(SEAL)

Joseph H. Gutride,
Secretary.

278,704

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Before Commissioners: Joseph C. Swidler, Chairman;
Lawrence J. O'Connor, Jr.,
Charles R. Ross, and
David S. Black

	Docket Nos.
Area Rate Proceeding	
Claud E. Aikman, *et al.*	AR61-1
North Central Oil Corporation (Operator), *et al.*	G-18466, *et al.* CI60-435, *et al.*

OPINION NO. 468-A

DENYING APPLICATIONS FOR REHEARING OF OPINION NO. 468

(Issued October 4, 1965)

SWIDLER, Chairman:

On August 5, 1965, the Commission issued its Opinion No. 468 in the above-entitled proceeding. Applications for rehearing have been filed by various parties. The applications in part consist of a repetition of contentions which were fully considered in the course of reaching the determinations embodied in Opinion No. 468. However, the applications have persuaded us that certain modifications are required in the quality standards prescribed in Opinion No. 468. In addition we wish to clarify certain findings in the opinion with respect to which questions have been raised and to respond to certain contentions not previously advanced.

(278,704)

Initially we note and reject the contention by the respondent Phillips Petroleum Company and by Independent Petroleum Association of America that the participation of Commissioner Black and the Chairman in the Opinion and Order herein was improper because they had demonstrated bias and prejudgment on the issue whether competition among producers can be relied upon to justify their contract prices as just and reasonable under the standards of the Natural Gas Act. Nothing which has transpired since the release of Opinion No. 447, in which we rejected an earlier motion to disqualify Commissioner Black, leads us to doubt the correctness of our

278,705

conclusion there. The views expressed therein are equally applicable to the attempt, belatedly and retroactively, to disqualify the Chairman on the basis of his speech of September 22, 1964, to the Independent Natural Gas Association of America of which we take notice.[1]

[1] Speaking personally, I am unaware of any bias or prejudgment on the issue of competition or any other issue in this proceeding. It would have been impossible for me to have worked four years as a member and Chairman of the Commission without acquiring some knowledge of the economic forces which affect natural gas pricing and forming opinions on how they operate. I have formed and expressed some opinions on the questions raised by proposed legislation to repeal FPC regulation over sales by gas producers in interstate commerce. My speech to INGAA expressed my belief that the Natural Gas Act as interpreted by the Supreme Court to apply to gas producers is necessary to protect the interests of the consuming public and made clear that on this legislative question I had not been persuaded by the arguments that competition between producers was an adequate substitute for regulation. These views on the need for producer regulation, however, did not prevent me from fairly evaluating the evidence in this proceeding bearing on the weight to be given to competition in determining the standards for fixing just and reasonable area rates. — JCS

Quality Standards

We shall now discuss three changes and clarifications which we are making in the quality standards:

Pressure

Several producer-applicants argue that the standard of 800 pounds pressure for pipeline quality gas is not realistic, pointing out that most of the gas delivered in the Permian Basin in 1960 was delivered below that pressure. We agree. While the record supports our conclusion that 800 pounds is the pressure generally employed in the principal mainline segment of the pipelines in the Permian Basin, our conclusion did not give sufficient weight to the pipeline systems operated in the Permian Basin at much lower pressure and to the

actual delivery standards in the area. Upon further consideration we believe that a pressure standard of 500 pounds would more nearly reflect the pressure at which gas is delivered to the pipeline systems in the Permian Basin.

Shell Oil Company (Shell) posed the problem of the unfairness of a quality deduction for sales of gas which the producer is ready and able to deliver at pressures higher than those at which the buyer can accept gas. We think that this point is also well taken. The delivery pressure for purposes of quality adjustments shall be the pressure at which the seller is ready and able to deliver gas into the buyers' facilities without further compression, even if such pressure must be reduced so that it can

be conveniently accepted by the buyers' established facilities at the point of delivery. Our previous order will be modified in this respect.

Btu Adjustment for Flowing Gas

In Opinion No. 468 we specified a Btu adjustment for new gas-well but did not do so for flowing gas. Upon reconsideration we are persuaded by the producers' argument that there is no adequate justification for this difference in treatment, and we agree that the price for both new gas-well gas and flowing gas should be related to its energy content. The producers correctly point out that otherwise the quality adjustments on flowing gas would operate in only one direction. There would be no upward adjustment for gas rich in energy, but which would nevertheless be subject to a downward adjustment because of excessive sulphur or low pressure. We believe the reasons stated for applying the Btu content standard to new gas-well gas apply equally to flowing gas and our previous order will be modified accordingly.

The Btu adjustment will be applied to the area base rate before price adjustments for quality. In view of the fact that a majority of contracts for gas-well gas provide for a payment for liquids removed by the purchaser, Btu content should be measured after the removal of such liquids where such payment is made.[2] To measure Btu's prior to extraction of the liquids and then pay a bonus for high Btu content in the form of liquids would be a double payment.

[2] The same principle would also apply in the case of similar contracts for residue or casinghead gas.

278,707

Carbon Dioxide Adjustments

Under Opinion No. 468 a producer with gas containing excessive amounts of carbon dioxide is paid on the basis of the volume of gas remaining after deduction of the above standard volumes of carbon dioxide. The application of the Btu adjustment provision to flowing gas makes possible a somewhat simpler handling of rates in contracts containing a high percentage of carbon dioxide. In addition to the method described above, we can now provide the producers with the alternative of pricing their gas on the basis of the volume actually delivered to the pipeline which still contains the carbon dioxide provided that the Btu content of the gas is also measured at that time. In these circumstances gas consumers will not be paying for carbon dioxide because the Btu content will be considerably below the minimum 1,000 Btu content established as an area standard in this proceeding and the price will be reduced accordingly.

Under either alternative the pipelines' cost of processing actually incurred to remove the carbon dioxide should be deducted from the area base rate to determine the applicable ceiling price. If the producer prefers to price his gas on the basis of the volume remaining after the carbon dioxide is removed, the Btu content for purposes of the adjustment provided herein shall be measured on the basis of the volume of gas after such removal and the total amount to be paid for gas should also be computed on the volume of gas remaining after the carbon dioxide has been removed.

(278,707)

Recovery of Processing Costs by the Pipelines

In setting forth the procedures in Opinion No. 468 for determining the amount of the reductions from the base price to reflect processing costs to bring the gas up to our quality standards, we provided that we would accept agreements between the producer and the pipeline as to the extent of the processing costs involved. It has been suggested that the likelihood of reaching agreement in most cases has been impaired by an indication in the opinion that if a pipeline agreed with producers upon the amounts of processing costs it could not thereafter claim more as part of its cost of service. We did not intend such an arbitrary rule. We

278,708

recognize, of course, that no negotiated cost can be expected to be absolutely accurate, that costs may vary over the years, that legitimate processing costs may be incurred to bring the gas up to a quality standard higher than we are prescribing for rate adjustment purposes, that some processing facilities must incorporate reserve capacity for use in pipeline operations, and that there are other legitimate processing costs that may be in incurred by a pipeline not accounted for in the negotiated price.

We emphasize our desire to encourage agreement between the parties as to the proper amounts to be paid or deducted for quality adjustments. While we do not intend to permit the agreements between producers and pipelines to be used for the purpose of establishing arti-

ficially low processing costs, with the pipeline and ultimately the consumer making up the difference, we will approve all such agreements which reflect a good faith effort to approximate the processing costs involved, and accept for the pipelines' rate purposes the adjustments computed thereunder. In reaching such agreements the parties may utilize average processing costs where cost data for individual contracts are not readily available. No pipeline need fear that any such agreement will prejudice its claims to its legitimate costs not covered by the agreement.

New Gas-Well Gas From Committed Acreage

The producers contend that frequently there may prove to be extensive gas deposits at horizons below those already tapped by oil or gas wells. They strongly argue that the development of acreage now committed under old gas contracts may be inhibited if future discoveries of gas-well gas from such acreage do not command the higher ceiling for new gas-well gas. We believe this point deserves further consideration.

There is merit to the contention that the basis for classifying additional discoveries of gas-well gas from deeper reservoirs should not depend solely on whether there has been prior dedication but rather on whether such classification will encourage the directional search for gas. The issue is thus whether the new gas-well gas ceiling is needed in the public interest for gas from committed acreage. One factor to be considered is that lease acquisition costs have already been incurred in connec-

tion with committed acreage. Another relevant question is how much information as to the existence of gas at lower levels is provided by wells that have already been drilled.

278,709

On a full record, the producers may well be able to demonstrate that gas discovered in new reservoirs separate from existing reservoirs and at lower depths should command the new gas ceiling irrespective of prior dedications. On this record, however, the issue was not developed by the parties sufficiently to serve as a basis for departing from our past policy of applying the new gas price only to gas that has not yet been committed to the interstate market.

We believe the issue should be fully developed in the *Hugoton-Anadarko* case, AR64-1, and any change in policy will be applied prospectively to the Permian Basin.

Revenues v. Costs

A major argument presented in the several producer applications for rehearing is that, because of the quality adjustments (presumably even as we are modifying them herein), the Commission has not fixed area rates at a level high enough to produce overall revenues which would in the aggregate match producer "costs." The argument fails to take account of the fact that the cost of gas-well gas that served as a yardstick for establishing the area rate includes a twelve percent rate of return (amounting to about 5 cents per Mcf) which the Commission expressly indicated was set at this figure in part

(and in the case of flowing gas, where the problem of low-quality gas is more pronounced, in large part) in order to compensate for the risk of finding gas of less than pipeline quality.

The producer's "revenue deficiency" argument is also in error in assuming that the flowing gas costs 14.5 cents per Mcf, or that the Commission so found. The Commission used the cost of flowing gas-well gas as the basic yardstick for fixing the price of all flowing gas (for the reasons stated in Opinion No. 468, pp. 70-77). While the cost of residue gas cannot be found with the precision requisite to serve as a basis for fixing ceiling prices, the evidence in the record makes clear that with respect to casinghead gas and residue gas derived therefrom (which together make up by far the largest share of the Permian gas subject to quality adjustments)

the costs are substantially below the 14.5 cents per Mcf ceiling price. For one thing the price includes a 4.08 cents allowance for exploration and development expense even though such gas was largely found as a by-product of the search for oil. For another, there would be no reason to allow producers a 12 percent rate of return on their investment for processing residue gas since the investment in processing plants and equipment is subject to few of the special risks incurred by those who explore for and develop reserves of gas.

We do not mean to suggest that the E&D allowance and the profit which we have provided for flowing gas is not fully justified, but we believe it is relevant to point

out that these two items, which account for 9.0 cents of the 14.5 cents price for flowing gas, are based in part on justifications other than cost, and provide ample allowance for the risk that low-quality gas in the area may not command the full area price.

It is relevant also in any comparison of revenues and costs in the Permian Basin to consider the additional producer revenues under the *Spraberry* contracts which govern the sale of approximately 20 percent of the gas sold in the Permian Basin. Under these contracts the producers will receive, in addition to the ceiling price for residue gas, substantial payments for the liquids which the pipelines extract from the unprocessed gas. The record does not reveal the precise amount of such revenues but the contracts and billing statements on file with the Commission confirm that they are substantial.

The producers' comparison of revenues and costs also fails to reflect a substantial amount of revenue which we did not take into account in any way in computing the cost of old gas-well gas, and which we may have underestimated in determining the new gas-well gas price. We refer to the payments received by the sellers of gas-well gas for liquid hydrocarbons extracted from the gas by the pipelines. El Paso points out in its application for clarification that these liquid credits approximate on the average 0.6 cents to 0.8 cents per Mcf in the Permian Basin. This may be contrasted with the plant liquid credit of 0.2 cents based on nationwide statistics used in computing the cost of new gas-well gas and the absence of any such credit against costs in the flowing gas computation.

The precise amount of the plant liquid credit which El Paso states it pays to the producers is not verified by evidence in the record although the contracts for the sale of gas-well gas in the area reveal that such payments are generally made. In these circumstances we do not believe it appropriate to adjust the cost to reflect this undetermined amount of additional producer revenue. However, it is clear that this revenue, which is separate and apart from payments for excess Btu's in the gas after removal of liquids, tends to offset any reduction in aggregate revenues due to downward quality adjustments.

The application by the Major Producers refers to "the Commission's finding that jurisdictional revenues will equate to jurisdictional costs." The Commission made no such finding. Obviously the Commission cannot allow higher rates to offset "revenue deficiencies" resulting from producer contract prices below the area ceiling. The Major Producers' own petition states that the "revenue deficiencies" resulting from these contractural limitations amounts to 0.76 cents per Mcf. It would be contrary to all regulatory principles to permit prices in excess of an otherwise just and reasonable rate for certain purchases merely because other sales had been voluntarily made at below full cost as herein determined.

It is argued that because it is impossible to quantify exactly the extent of quality discounts there can be no basis for determining the validity of the Commission's rate of return determination either as a whole or to the

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extent that it purports to reflect the risk of quality deficiency. The record does not leave us as much in the dark in this matter as the producers would have us believe. As Commissioner O'Connor stated in his concurring opinion, the record indicates that for gas-well gas under Opinion No. 468 "the reasonable amount of the average adjustment will be in a range of from 1.0 cents to 1.7 cents." With the changes we have here made with respect to quality standards, the average adjustments for gas-well gas will range from 0.7 cents to 1.5 cents, reduced by the additional revenue for plant liquids and the effect of the Btu adjustment.

278,712

As to the flowing gas, the additional upward adjustment for gas with a Btu content of more than 1,050 Btu, coupled with the change in pressure standards substantially reduces the amount of downward adjustments. We have already noted the offsetting revenues to the producers from liquid credits and the fact that the cost of residue and casinghead (the bulk of the gas in the area) is substantially lower than the 14.5 cents price.

While it is true that neither the amount of the downward quality adjustments or the offsetting sources of additional revenue can be determined precisely, we are convinced that the record fully justifies the Commission's judgment that the ceiling prices we have fixed "provide a fair relationship between the aggregate price the consumer pays and the aggregate costs that the producers incur" in the Permian Basin.

Flowing Residue Gas-Cost and Price

It has been stated in the applications of several producer-respondents that the price of residue gas derived from casinghead gas should be fixed at a higher price because the record contains evidence which would establish this cost at a level above the 14.5 cents per Mcf based on gas-well gas costs. The record does not support this argument. On the contrary, while a precise cost computation of residue gas cannot be made with sufficient assurance of accuracy to serve as a basis for fixing prices the evidence demonstrates that the cost of residue gas is lower than the cost of flowing gas-well gas. The defects in the evidence which the producers cite were pointed out by the examiner. (Initial Decision, pages 103-107.) The staff in its exceptions agreed with the examiner's downward adjustment of its figures. Without passing on the merits of the evidence it certainly does not support a higher price for residue gas.

The Differing Base Rates in Texas and New Mexico

Some of the applicants appear to have misunderstood the nature of our determination in fixing base rates for Texas production inclusive of production taxes, while fixing base rates for New Mexico to which present New Mexico taxes may be added. At the present time taxes in New Mexico are not

uniform, and different sales of natural gas within that state may be subject to quite different taxes. In the State of Texas, on the other hand, a production tax of 7 percent

applies uniformly to all sales. It is possible, therefore, to compute base rates including taxes which would be applicable to all Permian Basin production within the State of Texas. Since this is not possible with respect to New Mexico production, a different formula is used. The net result, however, is precisely the same for the two states — in each case the present taxes are included in computing the total prices which may be charged. This is not a determination that any and all taxes which the State of New Mexico may choose to impose in the future may be added to New Mexico base prices.

In its petition for rehearing El Paso requests the Commission to clarify whether in computing the applicable state and local production taxes for New Mexico there should be included the New Mexico Oil and Gas Ad Valorem Production Tax. The records of this proceeding show that such a tax is a property tax, not a production tax, and as such was included in our computation of the cost of finding and producing gas. Accordingly such tax shall not be included in computing the applicable New Mexico production taxes.

Refund Below the Last Clean Rate

First raised by Skelly, and repeated in other applications, is the contention that "the Commission's refund order exceeds its refund authority under Section 4(e) which is limited to the increased increment in the rate between the time the suspended increased rate is made effective and the date of the Commission's final order in the suspension proceeding." With this contention we

need not deal at this time, since no such situation has been presented as resulting from our order herein. It will be time enough to deal with this issue when and if it is established that any refunds below the last clean rate are required.

Classification of Gas on Basis of Contract Date

It has also been contended that contracts should not be classified as contracts for new or old gas by reason of the date of the contract, but rather on the basis of the date the gas was first committed to interstate commerce, assuming commitment occurred at a later date. We have chosen the

date set forth in the contract because that date is precise, definite and certain, whereas the date of commitment of gas to interstate commerce is less easy of ascertainment. We therefore do not believe any change in our decision on this issue is warranted.

Refunds — Pipeline Verification

We agree with El Paso that a condition should be attached to the refund requirement that it should be required that the purchaser verify the refund calculations, and the order accompanying this opinion will so provide.

Method of Rate Determination

Some confusion apparently exists with respect to the method of determining the proper price under a given contract. If a producer has a contract calling for a stated

price with specified increases for additional Btu content or specified deductions for certain quality deficiencies, the contract price is to be computed as though no price regulation existed. As a second step it will be necessary to compute the applicable area rate for the gas sold under the contract, without regard to the contract price provisions. The area rate will be the applicable base rate plus or minus the quality adjustments allowed or required by our decision and order. The proper rate to be charged and collected under the contract will be the contract price if it does not exceed the applicable area rate. If it exceeds the applicable area rate the latter will apply.[3]

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Rates Involved in Application of Order to Unconsolidated Section 4(e) Proceedings

In the Addendum to its Supplemental Application for Rehearing Shell inquiries whether ordering paragraph (E) of Opinion No. 468 applies to pending Section 4(e) proceedings not consolidated herein but which are subject to the Order to Show Cause issued in conjunction with Opinion No. 468. Paragraph (E) as previously

[3] For example, if a contract for new gas-well gas provides for a price of 16.0 cents with a proportionate upward Btu adjustment for Btu's in excess of 1,000 per Mcf, and the gas contains 1,030 Btu's per Mcf, the contract price would be 16.48 cents, assuming there are no other adjustments called for under the contract. The applicable area rate in Texas would be 16.5 cents per Mcf — the area base price with no upward or downward Btu adjustment, since 1,030 Btu's is in the range between 1,000 and 1,050. The proper rate chargeable under the contract would be 16.48 cents. If the same contract were for old gas-well gas produced in Texas the proper rate would be 14.5 cents since the applicable area rate would be lower than the contract rate.

modified requires that a supplement be filed by November 15, 1965, to each filed rate schedule in excess of the area base rate reflecting reductions to conform the filed rate to the area base rate. Pursuant to section 5(a) of the Act we have ordered all rate schedules of respondents which are in excess of area base rates to be reduced in conformity with paragraph (E). The fact that a respondent's rate schedule may be subject to an unconsolidated section 4(e) proceeding for a past period does not relieve respondent of filing a supplement in conformity with paragraph (E). The only remaining function of the unconsolidated section 4(e) proceeding is with respect to refunds for past periods to which the section 5(a) proceedings do not apply.

Requests for Stay of Order

A number of the producers have requested a stay of all or some of the ordering paragraphs of Opinion No. 468, until after completion of contemplated judicial review proceedings. Section 19(c) of the Natural Gas Act makes it clear a stay is not warranted for the sole reason that judicial review is to be sought. At a minimum, parties seeking a stay should demonstrate that any injuries they suffer, absent a stay, would be irreparable and would outweigh the irreparable injury to the public from granting the stay. See, *e.g.*, *Virginia Petroleum Jobbers Association* v. *F.P.C.*, 259 F. 2d 921 (CADC); *Associated Securities Corp.* v. *S.E.C.*, 283 F. 2d 773 (CA10); *Tennessee Gas Transmission Co.* v. *F.P.C.*, 283 F. 2d 729 (CA5).

The producers failed to make such a showing. If the order were set aside, the producers would not be precluded from recovering the difference between the rates collected and the rate which the producers should have been permitted to collect.[4] The Commission, in the event of judicial reversal, would have adequate authority, including power to fix future rates, to take any necessary corrective action to protect not only the producers but also the pipeline purchasers.

In any event, even a showing of irreparable injury would normally not be sufficient in itself to warrant a stay of a rate reduction or moratorium order when it is outweighed by the detriment to the public. As the courts have held (*e.g., Virginia Jobbers Association* v. *F.P.C.*, 259 F.2d 921 (CADC)), the effect of a stay on other interested parties and the public interest are of at least equal significance to the impact on private parties of its denial. In this case, grant of stay would mean the continued collection of rates which we have found, after careful consideration, to be excessive. Even if all such amounts were subject to refund requirements, it is well recognized that the protection afforded through the re-

[4] *Hunt Oil Company, et al.*, in their motion for stay, recognize this in their alternative suggestion that some of the ordering paragraphs, including paragraph (H), imposing the rate increase moratorium, be made effective "upon the express condition that to the extent that they are not judicially affirmed, if judicial review is sought thereon, they will be null and void *ab initio* and appropriate redress procedures would be adopted by the Commission to rectify any detriment which the Movants might suffer as a result of compliance with the Ordering Paragraphs which are subsequently reversed or modified."

fund procedure will not give full protection to the ultimate consumers. *F.P.C.* v. *Tennessee Gas Transmission Co.*, 371 U.S. 145, 154-155; *F.P.C.* v. *Hunt*, 376 U.S. 515, 524-525. We need not repeat the discussion set forth in Opinion No. 468 of why the moratorium of rate increases above the ceiling prices is essential. A stay of the moratorium would mean its elimination. As we observed

"Without a moratorium, the conclusion of one area proceeding would only signal the beginning of the next, and just and reasonable rates for consumers would always be one area proceeding away." [Opinion No. 468, p. 108]

Delay in giving effect to the ordered rate reduction in this case will be doubly injurious to the California consumer to whom most of the Permian gas is delivered, because it is our understanding that the Southern California distributing companies which purchase gas from El Paso and Transwestern also purchase substantial quantities of gas from California producers under long-term contracts in which the price is geared to the weighted average California border price for wholesale gas and is adjusted to reflect the border price in effect January 1 of each year. See *Re Pacific Lighting Gas Supply Co.*, 44 PUR 3d 177, 184 (Calif. P.U.C., 1962). Thus, a stay of the ordered rate reductions and the consequent delay in pipeline rate reductions would result in unrecoverable losses to the California distributing companies and presumably their customers. The Court of Appeals for the Fifth Circuit expressly took this factor into account in denying El Paso's request to stay the rate reductions ordered by us

in October 1962. *El Paso Natural Gas Co.* v. *F.P.C.*, CA5, No. 20180, December 21, 1962 (unreported).

Several producers also base their request in part on the assertion that, absent a stay, complex problems relating to royalty payments and state tax payments will have been created. It is not shown that such problems would cause irreparable harm. Moreover, as applicants recognize, any stay that might be issued should be on condition that all rates required to be reduced under Opinion No. 468 be collected subject to refund obligations at least for the period starting September 1, 1965, the effective date of Opinion No. 468. In view of this, it would not appear that an immediate rate reduction, with the opportunity for recoupment of undercharges in the event of judicial modification or reversal of our order, would create more complex problems with respect to royalty and tax payments than would exist with respect to the collection of rates subject to refund, pursuant to either a stay condition or existing requirements.

In these circumstances, the requested stay of the ordered rate reductions and the moratorium on increased rates would be totally unwarranted.

Even though the Opinion No. 468 does not require refunds to be made for rates collected prior to September 1, 1965, until further Commission action is taken, it is appropriate to indicate now that we will not take such further action until at least after the decision by the Court of Appeals which reviews Opinion No. 468. We

recognize that with respect to rates collected subject to refund for as much as 8 years prior to Opinion No. 468, the various inadequacies of the refund procedure as they relate to this case cannot be avoided even by immediate refunds. The prompt effectuation of just and reasonable rates for the future is of primary importance and the deferral of refunds due will provide additional insurance that our order in this respect cannot result in irreparable injury to the producers. Postponement of further Commission action requiring refunds is therefore deemed appropriate.

Other Matters

Certain producers presented contentions which related to their individual circumstances. Without suggesting that these contentions stated adequate grounds for special relief under Opinion No. 468 it is clear that they do not state any basis for modification of our area rate order which is of general application.

Numerous other arguments were advanced by producers in their application for rehearing but they have all been adequately disposed of by the full discussions supporting our findings and order in Opinion No. 468. The applications, therefore, should be denied except insofar as we have modified our order as provided herein.

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The Commission further finds:

(1) The quality standards and adjustments to the base area rates set forth in Opinion No. 468 and accompanying order should be modified as provided in the ordering provisions hereinafter set forth.

(2) The applications for rehearing and accompanying motions set forth no new facts or principles of law which either were not fully considered by the Commission when it adopted Opinion No. 468 and its accompanying order, or which now being considered warrant any change in, vacation or modification of such order, except as set forth herein.

(3) Good cause has not been shown for reopening this proceeding for receipt of additional evidence.

The Commission orders:

(A) Each and every reference in Opinion No. 468 or its accompanying order, or in Opinion No. 468-A or this accompanying order, to Texas Railroad District No. 8 shall be considered to include both the present Texas Railroad Districts 8 and 8-A.

(B) Paragraph (B) of the order issued together with Opinion No. 468 shall be amended to read as follows:

"(B) *Quality Standards and Adjustments to the Base Area Rates*

(1) The base area rates fixed in ordering paragraph (A) herein shall be adjusted for any deviations from the standards for pipeline quality gas in Texas Railroad District Nos. 7-c and 8, and in the New Mexico counties of Lea, Eddy and Chaves, which are hereby established as follows:

a. *Carbon Dioxide:* Pipeline quality gas shall contain not more than 3 percent carbon dioxide by volume.

b. *Hydrogen Sulphide:* Pipeline quality gas shall contain not more than 10 grains of hydrogen sulphide per Mcf of natural gas at 14.73 psia and 60° F.

c. *Total Sulphur:* Pipeline quality gas shall contain not more than 200 grains of total sulphur per Mcf of natural gas at 14.73 psia and 60° F.

d. *H_2O:* Pipeline quality gas shall contain not more than .009 pound of H_2O per Mcf of natural gas at 14.73 psia.

e. *Other Impurities:* Pipeline quality gas shall contain no oxygen, dirt, dust, gum, or other impurity in sufficient amounts to require the buyer to incur processing costs to eliminate such impurities in order for the gas to meet either customary commercial standards or the customary requirements of any of the interstate pipelines in the area.

f. *Pressure:* Pipeline quality gas shall be delivered at a pressure of not less than 500 pounds per square inch gauge.

g. *Btu Adjustment:* The maximum standard will be 1,050 Btu's per cubic foot at 14.73 psia and 60° F. and the minimum standard will be 1,000 Btu's per cubic foot at 14.73 psia and 60° F. Upward and downward adjustments of the base area rates will be on a proportional basis as specified at pages 99-100 of Opinion No. 468 if the Btu content exceeds the maximum standard or is below the minimum standard.

(2) When a purchaser buys gas which deviates from the quality standards established in subparagraph (1) above, the base area rate fixed in ordering paragraph (A) shall be adjusted for any deviations from such standards as follows:

a. The applicable base area rate shall be adjusted downward by the net cost, actually in-

curred prior to ultimate consumption, of processing the gas to bring it up to standard.

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(i) If the processing is performed by the purchaser, a reasonable return upon the net investment should be included as part of the processing cost incurred in bringing the gas up to pipeline quality.

(ii) If such processing reduces the volume of the gas, the purchaser shall pay for only the volume remaining after processing.

(iii) If the seller is ready and able to deliver natural gas into buyer's facilities without further compression, at pressures higher than the pressure at which the buyers' facilities available at the point of delivery can accept such gas, any downward adjustment for the cost of compression shall be limited to the cost of such compression as is incurred to raise the pressure of the gas from the pressure at which the seller is ready and able to deliver it up to the pressure standard of 500 psig.

b. The applicable base area rate shall be adjusted downward or upward by the amount of any applicable Btu adjustment.

c. In the case of delivery by seller of gas containing carbon dioxide in excess of the standards herein permitted, notwithstanding anything to the contrary in Paragraph (2)(ii) of this order, the producers shall have the alternative of receiving payment for the total volume of gas delivered, including the carbon dioxide,

provided that the Btu content of the gas is measured before removal of the carbon dioxide for the purposes of the Btu adjustments specified in this order, or receiving payment for the volumes exclusive of the carbon dioxide with the Btu content measured by the volumes of gas only."

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(C) Ordering paragraph (F)(1) of the order accompanying Opinion No. 468 is hereby amended by deleting "for new gas-well gas" from line 17 of said ordering paragraph.

(D) Ordering paragraph (I) of the order accompanying Opinion No. 468, designated "Refund Reports", is hereby amended by inserting after the first sentence of said ordering paragraph, the following:

"Within 10 days from the filing of the refund report the buyer shall file its written concurrence or disagreement with such report."

(E) Ordering paragraph (J) of the order accompanying Opinion No. 468 is hereby amended by changing "(E)" to "(I)" in line 2 thereof.

(F) Appendix A, Part III to Opinion No. 468 and its accompanying order is hereby amended as follows:

(a) Page 17, with reference to "Robertson, French, M. & J. P. Bryan (formerly G. Stratton, Jr. (Operator), *et al.*,)" insert a "**" after Docket No. G-16535.

(b) Page 21, delete "Sun Oil Company" and the related Docket No. "RI60-123."

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(c) Page 21, delete "Sun Oil Company (Operator), *et al.*" and related Docket No. "RI60-124."

(d) Page 7, with reference to "Aikman, Claude E.", delete Docket No. "G-18466."

(e) Page 21, with reference to "Superior Oil Company, The" delete Docket Nos. "G-18771" and "G-20075."

(G) Appendix D to Opinion No. 468 and its accompanying order is amended to conform to the form of Appendix D to Opinion No. 468-A and this accompanying order.

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(H) The applications for rehearing of Opinion No. 468 and accompanying order, and the motion of Hunt Oil Company, *et al.*, to reopen this proceeding for receipt of additional evidence, are hereby denied.

(I) The motions for stay of Opinion No. 468 and accompanying order, except to the extent granted by the Order Granting Time Extension issued September 28, 1965, in this proceeding, are hereby denied.

By the Commission. Commissioner O'Connor concurring filed a separate statement appended hereto.

(SEAL)

Gordon M. Grant,
Acting Secretary.

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ket Nos. AR61-1, et al.

APPENDIX D
(As amended by Opinion No. 468-A)

RATE SCHEDULE-QUALITY STATEMENT

1. APPLICABLE SECTION 4(e) DOCKET NO(S). (If any) (Use space below if needed)

RODUCER NAME

3. RATE SCHEDULE NO.

PE OF GAS (Check one)

-] NEW GAS-WELL GAS
- D. [ ] OLD GAS-WELL GAS
-] RESIDUE GAS DERIVED FROM NEW GAS-WELL GAS
- E. [ ] CASINGHEAD GAS
-] RESIDUE GAS NOT DERIVED FROM NEW GAS-WELL GAS
- F. [ ] MIXED GAS (Give proportion of types A and B)

ACE OF PRODUCTION (Give State, County, Field and Municipality)

ALITY OF GAS	PRODUCER'S STATEMENT OF QUALITY AND TREATING COSTS		BUYER'S STATEMENT OF QUALITY AND TREATING COSTS (If same as producer, indicate by check mark)	
	CONTENT OR PRESSURE	COST PER MCF OF TREATING GAS TO PIPELINE STANDARDS	CONTENT OR PRESSURE	COST PER MCF OF TREATING GAS TO PIPELINE STANDARDS
YDROGEN SULPHIDE CONTENT (In grains per Mcf)..				
OTAL SULPHUR CONTENT (In grains per Mcf).....				
O_2 CONTENT (Percentage of volume sold).....				
O CONTENT (In pounds per Mcf).....				
ONTENT OF OTHER IMPURITIES (Indicate whether bove or below customary commercial and pipe-ine standards).....				
CTUAL DELIVERY PRESSURE (Pounds per square inch)				
TOTAL				
TU CONTENT PER MCF				

PLICABLE AREA CEILING RATE
cents per Mcf

8. BTU PRICE ADJUSTMENT (State whether plus or minus)
cents per Mcf

PLICABLE RATE (Ceiling rate less treating costs, h Btu adjustments if any)
cents per Mcf

10. RATE HERE ESTABLISHED (Not above applicable ceiling rate as adjusted)
cents per Mcf

SAMPLE COPY

HING HEREIN SHALL PREVENT THE SELLER FROM FILING FOR ANY INCREASED RATE PERMITTED BOTH BY THE CONTRACT THE ABSENCE OF THIS STATEMENT) AND BY APPLICABLE ORDER OF THE FEDERAL POWER COMMISSION.

12. SIGNATURE OF SELLER, AGENT OR OPERATOR

TE OF STATEMENT

13. SIGNATURE OF BUYER

ERMS HEREIN ARE THOSE USED IN THE OPINION OF THE FEDERAL POWER COMMISSION IN PERMIAN BASIN AREA RATE EDING, AR61-1. NEW GAS-WELL GAS IS NATURAL GAS DERIVED FROM GAS WELLS MOVING UNDER CONTRACTS DATED ON TER JANUARY 1, 1961. THE BURDEN IS UPON A PRODUCER TO ESTABLISH THAT PARTICULAR GAS IS NEW GAS-WELL R RESIDUE GAS DERIVED THEREFROM, AND ALSO TO ESTABLISH THE PERCENTAGE OF SUCH GAS PRESENT IN A SALE XED GAS.

278,725

Area Rate Proceeding	*Docket Nos.*
Claude E. Aikman, *et al.*	AR61-1
North Central Oil Corporation (Operator), *et al.*	G-18466, *et al.* CI60-435, *et al.*

O'CONNOR, Commissioner, *concurring:*

Though concurring in the result reached by the majority, I do not rely upon their reasons, and I specifically re-emphasize my position in regards to the 50-Btu gap. It is apparent from the petitions for rehearing of our Opinion No. 468 that a strong possibility exists producers will not be in a position to realize aggregate revenues which reasonably approximate their aggregate costs. Since the specific problem is that of rate design for quality deviations, the impact of which cannot be determined on the record before us, rehearing is properly denied; nevertheless, once the impact is made clear by the quality adjustment determinations, it is entirely likely that rate revisions will be required.

It must be emphasized that, while the specific problem is that of proper quality adjustments, the impact of the overall adjustments can be burdensome to the extent the entire regulatory method is vulnerable. Clearly the impact of a regulatory rate must be considered, *F.P.C.* v. *Hope Natural Gas Co.*, 320 U.S. 591, 602 (1944), and, in the event the order does not permit the regulated enterprise an opportunity to recover its costs, then it must fall, *Natural Gas Pipeline Co.* v. *F.P.C.*, 315 U.S. 575, 590 (1942). This rule is applicable as well to group cost

regulation." Cf. *Bowles* v. *Willingham*, 321 U.S. 503, 517-519 (1943). Inherent in the majority opinion is an acknowledgment of this state of the law, and presumably a clear showing of an adverse impact will command revision. It is my position that further revisions will commend themselves to us once the quality impact is clarified.

The record does not permit a meaningful determination of the impact. As discussed in my separate opinion, the probable range will be 1.0 to 1.7 cents. This range is based upon various allegations of a general nature at the hearing and upon the ascertainable costs of processing out the deficiencies. The modified standard for pressure, and the general application of the upward Btu adjustment further alleviates the downward impact. In my opinion the upward adjustment from 1000 Btu's would represent a proper accommodation of costs to quality, and it should be adopted as a proper measure of quality standards. This is all the more compelling in light of the comprehensive study by Shell Oil Company in their Supplemental Petition for Rehearing. According to their figures the maximum

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downward impact could be in a range from 1.86 to 2.27 cents. Adjusted for the revised quality standards adopted today, this range could be 1.6 to 2.0 cents. If the quality impact is of these proportions modification may be required.

I reject the broad generalities relied upon by the majority for rejecting the cost-revenue argument. Their

broad conclusion that producers realize sufficient revenues in any event must be rejected. Federal regulation extends only to natural gas, and producers cannot be compelled to offset a deficit from the commodity with revenues from non-jurisdictional petroleum sales. Cf. *Baltimore & Ohio R.R.* v. *U.S.*, 345 U.S. 143 (1953). It is my position that where the public demands the creation of fettered enclaves of business enterprise, fundamental fairness requires that this same public shoulder the financial requirements of that enterprise. Further contradicting the majority position, it is far from clear that residue costs are less than gas-well costs. At the hearing and in argument before the Examiner, Staff initially took the position that residue costs were probably higher. To bury the quality impact in our rate of return determination is to overlook the basis for the 12 per cent allowance: comparable return on equity of 10-12 per cent by the far less risky operations of transmission companies. Finally, as regards self-imposed revenue deficiencies, many of the lower contracts apparently reflect quality deductions so that revenues realized under those contracts may remain below cost even under the quality standards we have prescribed.

The only proper basis for rejecting the quality impact argument is that the impact cannot be established. The actual conditions of delivery cannot be accurately determined from the record. Furthermore, the quality standards we prescribe may result in less onerous adjustments than the contracts require. We are thus left in the position of being unable to determine the impact. It is my

position that with the elimination of the Btu gap, any present doubts would disappear, and it is probable that no further adjustments would be required.

/s/ L. J. O'Connor, Jr.
L. J. O'Connor, Jr.
Commissioner

broad conclusion that producers realize sufficient revenues in any event must be rejected. Federal regulation extends only to natural gas, and producers cannot be compelled to offset a deficit from the commodity with revenues from non-jurisdictional petroleum sales. Cf. *Baltimore & Ohio R.R.* v. *U.S.*, 345 U.S. 143 (1953). It is my position that where the public demands the creation of fettered enclaves of business enterprise, fundamental fairness requires that this same public shoulder the financial requirements of that enterprise. Further contradicting the majority position, it is far from clear that residue costs are less than gas-well costs. At the hearing and in argument before the Examiner, Staff initially took the position that residue costs were probably higher. To bury the quality impact in our rate of return determination is to overlook the basis for the 12 per cent allowance: comparable return on equity of 10-12 per cent by the far less risky operations of transmission companies. Finally, as regards self-imposed revenue deficiencies, many of the lower contracts apparently reflect quality deductions so that revenues realized under those contracts may remain below cost even under the quality standards we have prescribed.

The only proper basis for rejecting the quality impact argument is that the impact cannot be established. The actual conditions of delivery cannot be accurately determined from the record. Furthermore, the quality standards we prescribe may result in less onerous adjustments than the contracts require. We are thus left in the position of being unable to determine the impact. It is my

position that with the elimination of the Btu gap, any present doubts would disappear, and it is probable that no further adjustments would be required.

/s/ L. J. O'Connor, Jr.
L. J. O'Connor, Jr.
Commissioner

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UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Before Commissioners: Joseph C. Swidler, Chairman;
Lawrence J. O'Connor, Jr.;
Charles R. Ross; and
David S. Black

	Docket Nos.
Area Rate Proceeding	AR61-1 *et al.*
North Central Oil Corporation (Operator) *et al.*	CI60-435
Socony Mobil Oil Company, Inc.	CI61-34
Robert T. Brown (Operator) *et al.*	CI61-733
Texaco Inc.	

ORDER DENYING REHEARING AND MODIFYING ORDER WITH RESPECT TO ISSUING CERTIFICATES

(Issued October 4, 1965)

On August 5, 1965, this Commission issued its order in this proceeding granting certificates of public convenience and necessity to four producers upon stated conditions, among which were included price conditions to the applicable area rates as established by Opinion No. 468 and accompanying order issued the same day. Applications for rehearing of Opinion No. 468 and the Order Issuing Certificates were filed by *North Central Oil Corporation, (Operator) et al.*, (North Central) and *Texaco Inc.*, two of the producers to whom certificates

were issued, and the applications of others for rehearing of Opinion No. 468 were also addressed to the Order Issuing Certificates. By Opinion No. 468-A and accompanying order issued this day we have denied the applications for rehearing of Opinion No. 468 and its accompanying order while modifying that opinion and order in certain respects.

North Central, in its application for rehearing states that its original contract was dated in 1960 but that the Supplemental Gas Purchase Agreement which was the subject of the same filing was dated March 9, 1961. It is North Central's contention that the gas dedicated under the supplemental agreement of March 9, 1961, is entitled to the new

gas-well gas price of 16.5 cents per Mcf, since the supplemental agreement was dated after January 1, 1961, the dividing date between old and new gas-well gas. North Central argues that it would be pure formalism to require a new and separate contract instead of a supplemental agreement in order to allow a producer to charge and collect the applicable area rate for new gas-well gas. We agree. Accordingly, our Order Issuing Certificates of August 5, 1965, will be modified to provide that the price condition in the certificate to be issued to North Central allow a price of 16.5 cents per Mcf for natural gas moving under the supplemental agreement of March 9, 1961.

One further matter requires clarification. The applications of *Socony Mobil Oil Company, Inc.*, (Docket

No. CI61-34) and *Texaco Inc.* (Docket No. CI61-879) involve Spraberry contracts discussed in detail in Opinion No. 468. Consistent with that discussion and the arguments advanced in the applications for rehearing we believe the applicable area rate should be applied to the residue volumes, with no deductions therefrom if the residue volumes meet the pipeline quality standards set forth in Opinion No. 468, as modified by Opinion No. 468-A. The consumers will thus pay no more for gas under the Spraberry contracts than any other gas of similar quality. As we indicated in Opinion No. 468, if the pipelines' processing costs exceed the liquid revenues the pipeline can petition for relief in the form of "an appropriate reduction in the price the pipeline pays for such residue gas." Our previous discussion in the Order Issuing Certificates herein is so modified. Any deductions required by contract must, of course, be utilized in determining the contract rate.

The applications for rehearing of the Order Issuing Certificates set forth no other facts or arguments which differ from those which were advanced and fully considered prior to our determinations of the issues in Opinion No. 468 and accompanying order and our determinations of the issues in the original Order Issuing Certificates. Accordingly, the applications for rehearing will be modified as previously stated.

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The Commission finds:

(1) The natural gas to be sold by *North Central Oil Corporation, (Operator) et al.*, under the Supplemental

Gas Purchase Agreement of March 9, 1961, is new gas-well gas as defined in Opinion No. 468 issued August 5, 1965.

(2) Except as stated herein, the arguments and assignments of error presented by the applications for rehearing warrant no change or modification in the Order Issuing Certificates issued August 5, 1965.

The Commission orders:

(A) Paragraph E of the prior Order Issuing Certificates issued August 5, 1965, is amended to read as follows: "The certificate granted to *North Central Oil Corporation (Operator) et al.*, is conditioned upon a total initial price including tax reimbursement of 14.5 cents per Mcf at 14.65 psia for all gas other than that sold pursuant to the Supplemental Gas Purchase Agreement dated March 9, 1961, and upon a total initial price including tax reimbursement of 16.5 cents per Mcf at 14.65 psia for all gas sold pursuant to the Supplemental Gas Purchase Agreement. On or before November 1, 1965, *North Central Oil Corporation, (Operator) et al.*, shall file a supplement or supplements to its presently filed rate schedule reflecting the conditioned prices as the initial prices in lieu of the initial price provided in the rate schedule.

(B) The applications for rehearing of the Order Issuing Certificates of August 5, 1965, are hereby denied.

By the Commission.

(SEAL)

Gordon M. Grant,
Acting Secretary.

UNITED STATES COURT OF APPEALS
TENTH CIRCUIT

Nos. 8385, 8409, 8440, 8455, 8458, 8460, 8479, 8482, 8487, 8488, 8489, 8490, 8493, 8494, 8495, 8496, 8497, 8501, 8505, 8510, 8511, 8517, 8519, 8521, 8528, 8529, 8534, 8540, 8541, 8542, 8588 and 8589

JANUARY TERM, 1967

SKELLY OIL COMPANY; PHILLIPS PETROLEUM COMPANY; WARREN PETROLEUM CORPORATION; MOBIL OIL CORPORATION (formerly Socony Mobil Oil Company, Inc.); PAN AMERICAN PETROLEUM CORPORATION; NORTHERN NATURAL GAS PRODUCING COMPANY; STANDARD OIL COMPANY OF TEXAS, a Division of Chevron Oil Company; TEXACO INC.; HUNT OIL COMPANY jointly with H. L. Hunt, Lamar Hunt, N. B. Hunt, W. H. Hunt, Secure Trusts, Caroline and Loyd B. Sands, Caroline Hunt Trust Estate, Lyda Hunt-Caroline Trusts, Lyda Hunt-Bunker Trusts, Lyda Hunt-Lamar Trusts, Lyda Hunt-Herbert Trusts, Lyda Hunt-Margaret Trusts (formerly Estate of Lyda Bunker Hunt, Deceased), Hunt Industries (formerly Estate of Lyda Bunker Hunt, Deceased), and Placid Oil Company; HUMBLE OIL & REFINING COMPANY; SHELL OIL COMPANY; THE ATLANTIC RICHFIELD COMPANY (formerly The Atlantic Refining Company) jointly with Dorchester Gas Producing Company, Southland Royalty Company, and Westates

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United States Court of Appeals
Tenth Circuit

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Petroleum Company; CONTINENTAL OIL COMPANY jointly with Sunray DX Oil Company, Sinclair Oil & Gas Company, Cabot Corporation, Sohio Petroleum Company, Joseph E. Seagram & Sons, Inc., Joseph E. Seagram & Sons d/b/a Texas Pacific Oil Company, Gulf Oil Corporation, Murphy Oil Corporation, The Nueces Company, Samedan Oil Corporation, Cities Service Oil Company (formerly Cities Service Petroleum Corporation), Cities Service Production Company (now merged with Cities Service Oil Company), Columbian Fuel Corporation, Amerada Petroleum Corporation, Union Oil Company of California and as successor to The Pure Oil Company, Tidewater Oil Company, Reef Corporation, and William A. & Edward R. Hudson, Joint Operators; MARATHON OIL COMPANY; SUN OIL COMPANY; INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA; THE BRITISH-AMERICAN OIL PRODUCING COMPANY; UNION TEXAS PETROLEUM, a Division of Allied Chemical Corporation; MIDHURST OIL CORPORATION; THE SUPERIOR OIL COMPANY; PERRY R. BASS jointly with Panther City Investment Co., Bass Bros. Enterprises, Inc., Perry R. Bass, Incorporated, and Richardson Oils, Inc.; COLUMBIAN CARBON COMPANY jointly with Coltexo Corporation; THE STATE OF TEXAS; BIG CHIEF DRILLING COMPANY jointly with King-Stevenson Oil Company, Inc., and Service Drilling Company; TEXAS INDEPENDENT PRODUCERS AND ROYALTY OWNERS ASSOCIATION jointly with West Central Texas

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Oil and Gas Association; STATE OF NEW MEXICO; GULF OIL CORPORATION; and J. C. BARNES, *et al.*,

Petitioners,

v.

FEDERAL POWER COMMISSION,

Respondent,

STATE OF CALIFORNIA jointly with Public Utilities Commission of the State of California; CITY OF LOS ANGELES; CITY OF SAN DIEGO; CITY AND COUNTY OF SAN FRANCISCO; PACIFIC GAS AND ELECTRIC COMPANY; PACIFIC LIGHTING SERVICE AND SUPPLY COMPANY (formerly Pacific Lighting Gas Supply Company) jointly with Southern California Gas Company and Southern Counties Gas Company of California; and SAN DIEGO GAS AND ELECTRIC COMPANY,

Intervenors.

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Tenth Circuit

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Before LEWIS, BREITENSTEIN and HILL, *Circuit Judges.*

BREITENSTEIN, Circuit Judge.

The first area rate decision of the Federal Power Commission is before us for review. It relates to prices for jurisdictional sales of natural gas produced in the Permian Basin, a famous petroleum area where oil and gas are found in hundreds of reservoirs and thousands of wells. The states of Texas and New Mexico, the nation's oil and gas industry, and several related associations attack the decision. The State of California, the cities of San Francisco, Los Angeles, and San Diego, various local distributors, and an organization of such distributors supported. The rejection of the individual company cost-of-service approach to the regulation of independent producers and the adoption of the area rate method raise many novel issues which have been extensively and ably argued. We hold that neither the United States Constitution nor the Natural Gas Act bars the regulation of natural-gas prices on an area basis; that the Commission did not abuse its discretion in adopting the area method; and that the cases must be remanded because the actions of the Commission do not comply with the end result test established in Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 602-603, and other decisions.

The petitions for review, all brought under § 19(b) of the Natural Gas Act,[1] attack Opinions Nos. 468 and 468-A of the Commission fixing just and reasonable rates

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[1] 15 U.S.C. §§ 717-717w.

under §§ 4 and 5 of the Act for natural gas produced in the Permian Basin and sold to interstate pipeline companies.

1. *Background.*

The Permian Basin, as defined by the Commission, includes Texas Railroad Commission Districts Nos. 7-C, 8, and 8-A and the New Mexico counties of Chaves, Eddy, and Lea. Nationally, it accounts for about 11% of all the gas sold in interstate commerce. The Commission joined 336 producers as respondents in the consolidated proceedings. Sales by them are made to three interstate pipelines, none of which appear here.[2] About 85% of the Permian gas moving interstate goes to California.

Nearly two-thirds of the Permian gas production comes from oil-well gas, that is, gas produced in conjunction with oil. Because of impurities much of the gas must be processed before introduction to an interstate pipeline. Until El Paso began its purchases, Permian oil-well gas was generally vented or flared because of the lack of a market.

The natural-gas industry has three main parts, the producers, the interstate pipelines, and the distributors. The last are under state or local regulation exclusively. The Commission began federal regulation of the interstate pipelines after the passage of the Natural Gas Act

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[2] El Paso Natural Gas Company began buying Permian gas in 1945, Northern Natural Gas Company through a predecessor in 1954, and Transwestern Pipeline Company in 1958. In 1961, El Paso purchased 73% of the Permian gas moving in interstate commerce, Northern 18%, and Transwestern 9%.

of 1938. It did not attempt to regulate independent producers[3] until the 1954 decision of the Supreme Court in Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672, (First Phillips) which held that the Act applied to them.

Section 7 of the Act forbids the sale of natural gas subject to Commission jurisdiction without a certificate of public convenience and necessity granted after notice and hearing. Temporary certificates, issued without notice and hearing, are authorized. Our recent decision in Sunray DX Oil Company v. Federal Power Commission, 10 Cir., ... F.2d ....., discusses § 7 procedures and problems. These are not present here because the § 7 applications considered in the consolidated proceedings before the Commission were disposed of in a separate order.

Section 4 requires that all rates shall be just, reasonable, and nondiscriminatory. No change shall be made in a rate without 30 days' notice. When a schedule containing a changed rate is filed, the Commission on its own initiative or on complaint may suspend the rate and set the matter for hearing. The suspension may be for not longer than five months. If no decision is reached within that period, the increased rate becomes effective but the Commission may require a bond conditioned upon the refund of that portion of the increased rate found not to be justified. The instant proceedings involve a number of increased rate filings which were suspended under

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[3] The word "independent" is used to describe a producer which does not transmit gas interstate either by its own operations or those of an affiliate. Some of the interstate pipelines produce a share of their own gas and sell gas to other pipelines.

§ 4 and which were disposed of by Opinions Nos. 468 and 468-A.

Section 5 provides that whenever the Commission, after hearing had on its own motion or on complaint, finds that a rate is "unjust, unreasonable, unduly discriminatory, or preferential" it shall determine "the just and reasonable rate." In the proceedings at bar the Commission pursuant to § 5 established "the future rates for jurisdictional sales of gas by producers in the area."

After the First Phillips decision the Commission received thousands of certificate applications from producers. The situation was complicated by the need of pipelines for a committed source of supply sufficient to justify financing. To obtain such supply long-term contracts, commonly for 20 years, were made with the producers. They in turn, because they could not file unilaterally for an increased rate contrary to contract and because they desired protection against the unforeseeable economic conditions of the future, insisted on escalation clauses of various types.[4] A general price rise occurred. As the escalation provisions became operative the producers filed under § 4 for increased rates and the Commission suspended many of them. Section 7 applications were under contracts calling for rates comparable to those which the Commission had suspended. This trend was ended by the 1959 decision in Atlantic Refining Co. v. Public Service Commission of New York, 360 U.S. 378, (CATCO) which directed the Commission in certificate cases to keep initial prices in line.

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[4] See Pan American Petroleum Corporation v. Federal Power Commission, 10 Cir., 352 F.2d 241, 243.

After the remand in First Phillips, the Commission proceeded with the consideration of just and reasonable rates required by §§ 4 and 5 on the individual company cost-of-service basis which it had long applied in the regulation of electric power companies and interstate pipelines. The first case to reach the decisional stage was that relating to Phillips. On September 28, 1960, the Commission entered Opinion No. 338[5] in which it held that the regulation of independent producers under the Act could be accomplished more appropriately by the establishment of area rates than by the establishment of producer rates on individual cost-of-service findings. Contemporaneously with this Phillips decision, the Commission promulgated its Statement of General Policy No. 61-1[6] which established 23 rate areas and, with unimportant exceptions, announced maximum rates for each area. Two price standards were set, one for initial prices in new contracts and one for escalated prices in existing contracts. For the Permian Basin area the prices were 16 cents and 11 cents respectively.

Opinion No. 338 was affirmed by the Court of Appeals for the District of Columbia Circuit[7] and by the Supreme Court in Wisconsin v. Federal Power Commission, 373 U.S. 294, 310, (Second Phillips) wherein the Court observed that it shared "the Commission's hopes that the area approach may prove to be the ultimate solution" to the problem of regulating the independent producers.

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[5] 24 FPC 537.

[6] 24 FPC 818.

[7] Wisconsin v. Federal Power Commission, D.C. Cir., 303 F.2d 380.

The first area rate proceeding was that for the Permian Basin and was initiated on December 23, 1960.[8] It was followed by a similar proceeding for the South Louisiana area,[9] for the Hugoton-Anadarko area,[10] and for the Texas Gulf Coast area.[11] The last three are in the hearing stage. The Permian Basin proceeding was decided by Opinions Nos. 468 and 468-A to which we turn.

2. *The Decision of the Commission.*

The 131-page original opinion, No. 468, followed by the 23-page opinion denying rehearing, No. 468-A, need only be summarized at this point. The Commission found the area rate principle free from constitutional and statutory objections and adopted it. Contract prices were rejected as a basis for regulation and the reserves to production ratio was declared to be an inappropriate regulatory standard. The Commission set up a two-price system. It differentiated between gas produced as the sole product of a well, referred to as gas-well gas, and gas produced in association with oil, known as oil-well gas or casinghead gas. One price was established for new gas-well gas and the residue therefrom sold under contracts made on or after January 1, 1961. A second price was established for flowing gas which was defined to include gas-well gas sold under contracts executed before the mentioned date, casinghead gas, and residue gas derived from either source. The January 1, 1961, date of division between new gas-well gas and old gas-well gas was

[8] Docket No. AR61-1, 24 FPC 1121.
[9] Docket No. AR61-2, 25 FPC 942.
[10] Docket No. AR64-1, 30 FPC 1354.
[11] Docket No. AR64-2, 30 FPC 1354.

adopted because that was the approximate date when the industry became able to direct its exploration efforts toward finding gas-well gas as distinguished from finding gas as a by-product in the search for oil. For new gas-well gas the Commission fixed a rate of 16.5 cents per Mcf for the Texas Railroad Districts inclusive of state and local taxes and a rate of 15.5 cents per Mcf for the New Mexico counties exclusive of applicable state and local production taxes. For flowing gas the respective rates were 14.5 cents and 13.5 cents.

In determining these rates the Commission gave consideration to composite costs but treated the two categories of new gas-well gas and flowing gas differently. It said that the price of the former "was geared to the cost of finding and producing future gas supplies and as such was built up primarily from nationally published statistics and the questionnaire data." For flowing gas it said "our touchstone is the historical cost of gas being produced in the Permian Basin area."

The Commission required adjustment on an individual company basis from the stated prices to reflect differentials from the quality standards. These downward adjustments are determined "by the net cost of processing the gas to bring it up to standard." A downward adjustment is also required if the Btu content is less than 1,000 per Mcf and an upward adjustment is permitted if that content is above 1,050.

Small producers, defined as those making less than 10 million Mcf of jurisdictional sales annually, are exempt from the quality adjustments and from certain filing requirements.

The Commission set a minimum price of 9.0 cents per Mcf. Provision is made for special exemption from area rates. Refunds of excess collections are required on an individual company basis. The possibility of changes in area rates is recognized. A moratorium, until January 1, 1968, is declared on rate increases and indefinite escalation clauses are prohibited.

Three commissioners filed separate opinions. With one exception Commissioner O'Connor approved the results reached but said that "the contract price at which most producers are able and willing to operate is just and reasonable" and that "composite costs best serve as a check on average field prices to preclude significant price departures." He disapproved the Btu adjustment saying that an upward adjustment should be applied for all gas having a Btu content in excess of 1,000. Commissioner Ross was critical of accounting methods used and pointed out the need for simplification. He dissented from the division date between new and old gas-well gas. In his view the new gas-well gas price should apply to gas sold after the date of the Commission decision. Commissioner Black said that the allowed 12% rate of return on net investment "is very probably a generous one" but was justified by the special risk of finding substandard gas in the Permian Basin.

3. *Disqualification of Two Commissioners.*

The Continental Group of petitioners urges that Commissioner Black was disqualified to participate in the decision. The Independent Petroleum Association of America, (IPAA) complains of the participation of both

Commissioners Swidler and Black. The claim is that each of them had prejudged the issue of whether substantial competition existed among producers. Additionally, Commissioner Black is accused of personal bias against the producers. The charges stem from public addresses made in 1964.[12] No claim is made that either commissioner prejudged the ultimate issue of a just and reasonable rate. In our opinion no basis for disqualification arises from the fact or assumption that a member of an administrative agency enters a proceeding with advance views on important economic matters in issue. Nothing in the record disturbs the assumption that the two commissioners are "men of conscience and intellectual discipline, capable of judging a particular controversy fairly on the basis of its own circumstances."[13] The cases cited by Continental and IPAA are not in point.[14]

4. *Objections of Texas and New Mexico.*

The states of Texas and New Mexico, besides adopting the briefs and arguments of the Continental Group, assail the Commission decision on grounds peculiar to

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[12] A motion for the disqualification of Commissioner Black was made to and denied by the Commission. We find no similar motion in the record pertaining to Commissioner Swidler.

[13] United States v. Morgan, 313 U.S. 409, 421. See also Federal Trade Commission v. Cement Institute, 333 U.S. 683, 700-703.

[14] In Texaco, Inc., v. Federal Trade Commission, D.C.Cir., 336 F.2d 754, vacated 381 U.S. 739, the charge was precommitment of a commissioner on the guilt of an accused. In Gilligan, Will & Co. v. Securities and Exchange Commission, 2 Cir., 267 F.2d 461, certiorari denied 361 U.S. 896, a similar charge was made against a commission. Amos Treat & Co. v. Securities and Exchange Commission, D.C.Cir., 306 F.2d 260, related to a charge against a commissioner who had previously served as a staff member in the investigation which led to the complaint.

them in their governmental capacity. They say that the public interest, which the Commission is required to protect, includes the producing states as well as the consuming states; that the prices which the Commission has set will cause a cessation or curtailment of exploration and development activities to the serious injury of the economy of the Permian Basin; that waste rather than conservation of a natural resource will result; and that the states and their public entities will suffer severe losses in taxes and royalty payments.[15] Similar arguments were made by West Virginia in Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 607-614, and were rejected by the Supreme Court which said that when Congress passed the Natural Gas Act it "was quite aware of the interests of the producing states in their natural gas supplies" and that nothing in the Act intimates that high prices should be maintained so that "the producing states obtain indirect benefits." The rejection of the state's contentions in Hope requires the rejection of the same contentions here.

Texas and New Mexico also argue that the Commission has unlawfully interfered with their power of taxation. The Commission fixed the rates of gas produced in Texas to include all state taxes and in New Mexico to exclude such taxes. It said that: "In the event of any increase in taxes in Texas or New Mexico, the Commission will consider whether ceiling prices shall be increased and, if so, to what extent." The states' arguments

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[15] In Texas 4.7 million acres of public lands are within the Permian Basin and in New Mexico over 3 million acres. Much of this land is leased for oil and gas and produces royalty income.

are premature. The Commission has allowed all present taxes as a cost item. Nothing in the Commission decision inhibits the states from increasing those taxes. The Commission has said that if they do, it will determine whether such increases should be passed on to the consumer or remain on the shoulders of the producers. The question of whether increased state taxes will unreasonably burden interstate comerce is hypothetical at this stage.

New Mexico complains that the establishment of a ceiling price plus existing taxes for gas produced in its portion of the Permian Basin denies to it the power to provide a tax incentive to producers by reducing the tax. The argument is not persuasive. If the New Mexico tax was reduced, the Commission could properly consider a rate decrease to reflect the tax decrease.

5. *Legality of Area Rates for Permian Basin.*

The problems confronting federal regulation of the natural-gas business, and particularly the independent producers, have been discussed several times[16] and need be only summarized. The interstate gas business is concerned with a wasting, nonreplenishable natural resource subject to production after discovery. At the point where the gas enters interstate commerce there are few buyers

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[16] See opinions of Justice Jackson dissenting in Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 628; and concurring in Colorado Interstate Gas Co. v. Federal Power Commission, 324 U.S. 581, 608; dissenting opinion of Justice Douglas in First Phillips, 347 U.S. 672, 687; dissenting opinions of Justice Clark in First Phillips, 347 U.S. 672, 690, and in Second Phillips, 373 U.S. 294, 315; dissenting opinion of Justice Harlan in Sunray Mid-Continent Oil Co. v. Federal Power Commission, 364 U.S. 137, 159; and Opinion No. 338 of the Commission, 24 FPC 537, 542-548.

and thousands of sellers. The producers range from the financially powerful integrated oil companies to the wildcatters who operate on a shoestring. Their results are measured by the amount of gas produced — not by the amount of money invested. Exploration and development costs are financed out of current income and are charged to expense rather than capital. The uncertainty of the business causes substantial cost and revenue fluctuations not only from producer to producer but also from year to year for the same producer. A regulated commodity, gas, is produced in substantial quantities along with an unregulated commodity, oil. The allocation of costs between them baffles the experts and presents the temptation to use mathematical means of arriving at a predetermined result. The same rate may bring a financial windfall to one producer and a financial disaster to another. The price of gas must be competitive with that of other sources of energy and must be sufficiently attractive to encourage a continued search for new supplies.

In Federal Power Commission v. Natural Gas Pipeline Co., 315 U.S. 575, 582, a case relating to pipeline rates, the Court held that the provisions of the Act were consistent with the due process clause of the Fifth Amendment and within the commerce power. Another pipeline case, Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 602, says that in fixing rates the Commission is "not bound by the use of any single formula or combination of formulae"; that "under the statutory standard of 'just and reasonable' it is the result reached not the method employed which is controlling"; and that the impact of the rate order rather than the theory behind

it is, the governing criterion. The "end result" test of Hope was followed in Colorado Interstate Gas Co., v. Federal Power Commission, 324 U.S. 581, 605-606.

Second Phillips, 373 U.S. 294, holds that the Commission did not abuse its discretion in terminating the § 5 investigation of Phillips' rates and substituting an area basis for an individual company basis. The Court reaffirmed the principles announced in Natural, Hope, and Colorado Interstate, recognized the difficulties inherent in the regulation of the price of natural gas, shared the Commission's hopes for the success of the area approach, and observed that the "case might be different if the area approach had little or no chance of being sustained."[17] At the same time, the Court pointed out that "the lawfulness of the area pricing method" was not before it for review.[18] Four justices dissented in an opinion which characterized the area rate policy of the Commission as "a new, untried, untested, inchoate program which, in addition, is of doubtful legality."[19]

In Callery[20] the Court mentioned that the § 7 proceedings before it had at one time been consolidated with the South Louisiana area rate proceedings. Contrary to the argument of the California Distributors the Court did not, tacitly or otherwise, approve area rate regulation. The most pertinent comment is that of Justice Harlan in his concurring and dissenting opinion who said that area

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[17] 373 U.S. 294, 310, 314.

[18] Id. at 308.

[19] Id. at 317.

[20] United Gas Improvement Co. v. Callery Properties, Inc., 382 U.S. 223, 225-226.

pricing "ultimately aims to simplify proceedings under the statute."[20a]

We cannot accept the arguments of the Commission and the California groups that the Supreme Court has determined the validity of area pricing under the Act. We read the decisions to mean that the Court has permitted the Commission to go forward with the area rate experiment and wishes it good luck in the development of a workable procedure which will be free from constitutional and statutory pitfalls.

Governmental price regulation of services and commodities on a group for geographical basis has been upheld in a number of decisions[21] under the federal commerce and war powers and under state police powers. Those supporting the Commission place great reliance on these decisions. The producers painstakingly distinguish each from the case at bar. We decline to be drawn into these tortuous sidepaths because we are convinced that the "translation of an implication drawn from the special aspects of one statute to a totally different statute is

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[20a] Id. at 231.

[21] See The New England Divisions Case, 261 U.S. 184 (ICC - divisions of joint rates); Aetna Insurance Co. v. Hyde, 275 U.S. 440 (Missouri regulation of fire insurance rates); Tagg Bros. v. United States, 280 U.S. 420 (Packers and Stockyards Act of 1921); Nebbia v. New York, 291 U.S. 502 (New York Milk Control Act); United States v. Rock Royal Co-op., 307 U.S. 533 (Agricultural Marketing Agreement Act of 1937); Sunshine Anthracite Coal Co. v. Adkins, 310 U.S. 381 (Bituminous Coal Conservation Act); Bowles v. Willingham, 321 U.S. 503 (Emergency Price Control Act of 1942); New York v. United States, 331 U.S. 284 (ICC - railroad rates); and Ayrshire Collieries Corp. v. United States, 335 U.S. 573 (ICC - railroad rates).

treacherous business."[22] Specific reference need be made to only one decision. Several producers emphasize the statement in Bowles v. Willingham, 321 U.S. 503, 517, that in the Natural Gas Act "Congress has provided for the fixing of rates which are just and reasonable in their application to particular persons or companies." The argument is that by this language the Supreme Court has recognized that regulation under the Act is on an individual company rather than group basis. We do not agree. The statement is dicta and whatever value it might have had as dicta was, in our opinion, destroyed by the blessing which the Court gave area rate making in Second Phillips.

Producers urge that the language of the Act is contrary to regulation on a group basis because all pertinent references to natural-gas companies are in the singular. First Phillips holds that an independent producer is a "natural-gas company" within the purview of the Act. Section 2, the definitions section, provides that "person" means an individual or corporation, and defines "natural-gas company" to mean a person engaged in transportation or sale of natural gas in interstate commerce. Section 4, covering the filing and changing of rates, refers to "any natural-gas company," "no natural-gas company," "every natural-gas company," and "the natural-gas company." Section 5, authorizing investigation and determination of rates, refers to "any rate," by "any natural-gas company" and to "such natural-gas company." Section 7 provides for certificates of public convenience and necessity and uses the terms "a natural-gas company," "no natural-gas

[22] Federal Trade Commission v. Bunte Bros., 312 U.S. 349, 353.

company" and "such natural-gas company." The repeated use of the singular rather than the plural is said to require that the just and reasonable rate of each particular seller be tested with reference to its peculiar circumstances and operations.

Opposing arguments point out that the Act does not prohibit group or area rate making and that § 16 empowers the Commission to perform any and all acts and to prescribe such orders, rules, and regulations "as it may find necessary or appropriate to carry out the provisions of this act."

The basic query is whether the just and reasonable standard applies on an individual company basis or on a group basis. Section 4(a) says that "all rates * * * made * * * by any natural-gas company * * * shall be just and reasonable * * * ." If this means that each producer is entitled to a rate which will return its costs plus a reasonable profit, the inquiry is at an end because the Commission refused to receive individual cost figures.

The Natural, Hope, Colorado Interstate, and Second Phillips decisions all support the conclusion that in the regulation of natural-gas rates the Commission is not bound by any formula or method, and that the choice of the appropriate method for the determination of those rates lies in the sound discretion of the Commission. The appropriateness of the method depends on the peculiar characteristics of the natural-gas industry.

In its Opinion No. 338,[23] the Commission noted the reasons why the individual company cost-of-service

[23] 24 FPC 537.

method was inapplicable and unworkable. Among these were the lack of a fixed determinable relationship between investment and service to the public with the result that "a huge investment might yield only a trickle of gas, while a small investment might lead to a bonanza," the staggering allocation problems which could result in such anomalies as widely varying prices for gas coming from a jointly owned lease or even from a jointly owned well, and the intolerable administrative burden of requiring a separate rate determination for each of the several thousand independent producers.

The powerful contrary argument is that no area rate, whether based on composite costs, average aggregate costs or any other industry wide criteria, will suffice to assure a high cost producer of its costs to say nothing of a profit. We accept this as true.[24] The impact of an area rate in the natural-gas industry may have effects which cover the entire range from bonanza to bankruptcy. It is sufficient for us that these results were lucidly demonstrated in the dissenting opinion of Justice Clark in Second Phillips and did not deter the majority from allowing the Commission to proceed with its area rate program.

Some of the producers argue that if the Act is construed to permit area rate making, the Act is invalid under

[24] An appendix to the Hunt brief presents an array of natural-gas costs of 44 Permian producers whose volumes total over 208 million Mcf. Of these, 16 producing over 170 million Mcf are shown to have costs of less than 14.5 cents. The remainder have costs running from 14.77 cents to 216.05 cents. We have been unable to check the accuracy of these figures and mention them only to show the claimed disparity of costs. Continental says that "approximately 67 percent of the companies and approximately 30 percent of the volumes had costs above the industry average cost level."

Art. I, § 1, of the United States Constitution because no legislative standards have been set for establishing groups or making group determinations. Reliance is had on Panama Refining Co. v. Ryan, 293 U.S. 388, which held that a delegation of legislative power to the President was unconstitutional because Congress, among other things, "has declared no policy, has established no standard, has laid down no rule."[25]

Congress cannot delegate its power to enact laws but it can confer on an administrative agency the power to carry into effect laws which it has enacted.[26] In the New England Divisions Case, supra, the Court referred to the power given by Congress to the Interstate Commerce Commission to determine just and reasonable rates and said that Congress "intended that a method should be pursued by which the task * * * could be performed."[27] In Lichter v. United States, 334 U.S. 742, 785-786, the Court in discussing legislative standards said that the "standards prescribed by Congress are to be read in the light of the conditions to which they are applied" and for an example observed that "among those which have been held to state a sufficiently definite standard for administrative action [are] 'just and reasonable' rates for sales of natural gas."

In the regulation of the natural-gas industry "the actual necessities of procedure and administration"[28] have led to the adoption of the area rate method. We believe that

[25] 293 U.S. 388, 430.

[26] Crain v. First National Bank of Oregon, Portland, 9 Cir., 324 F.2d 532, 537.

[27] 261 U.S. 184, 197.

[28] Id. at 198.

neither constitutional nor statutory provisions prevent the use of that method and that the Commission did not abuse its discretion in adopting it. The more important and difficult question is that of the validity of the area rates which have been established. The controlling standard is the end result test of Hope. In our opinion, this test is accepted by, and reaffirmed in, the Second Phillips decision.

Some of the producers urge that the area rate method is not consistent with the characteristics of the industry and that contract prices satisfy statutory requirements because they have been reached through effective competition. The Commission considered and rejected the argument. It pointed to the history of price negotiations in the Permian Basin, to the urgent requirements of the pipelines, to the heavy percentage of sales by a few producers, and to the control of undisclosed and uncommitted gas reserves by a few producers. It concluded that the record fails to establish that a just and reasonable rate can be established through competition and that "the primary competition revealed by the record was among the pipelines to secure new gas supplies at higher prices." Commissioner O'Connor disagreed saying that "the contract price at which most producers are able and willing to operate is just and reasonable." His conclusion was that "profit oriented costs and supply oriented contracts do not, in the aggregate, depart in any significant manner from each other." We accept the conclusion of the Commission that competition has not been effective to fix a just and reasonable rate. It is supported by reasonable inferences from the record and they are binding on us.

Continental and Superior say that they were improperly denied an opportunity to be heard on the geographical propriety of the Permian Basin as a rate area. In its order instituting the proceedings the Commission eliminated the issue of the appropriateness of the area for rate making purposes.[29] The Commission may draw on its expertise to determine the ground rules for an investigation but in so doing may not deny a specific right.[30] The producers fail to convince us that any such denial has occurred here. The Permian Basin is a well known area. Unless prices are to be determined on a national basis, areas must be selected and defined. The Commission had two choices. It could first determine the national revenue requirement and divide that up among the areas or it could first determine the various rates so that in the aggregate they meet that requirement. We are unwilling to assume that when all the area proceedings are completed the total revenue will not equal the national requirement. If it does not, both the producers and the consumers will suffer. In our opinion the Commission acted reasonably in selecting the Permian Basin for an area rate proceeding.

6. *The Two-Price System.*

The Commission's two-price system is vigorously attacked on many fronts. It will be remembered that one price is fixed for new gas-well gas and another for flowing gas. All agree that gas is a commodity which is valuable as a source of energy. The householder does

[29] 24 FPC 1121, 1122.

[30] Amax Petroleum Corporation v. Federal Power Commission, 10 Cir., 350 F.2d 92, 94.

not care whether the gas which burns at the tip of his appliance comes from a gas well, an oil well, or as a residue product. To him gas is gas.

The justification for the two-price system is that the higher price for new gas-well gas provides an incentive to explore for and develop new supplies. The producers do not question the finding that "the industry is increasingly becoming able to direct its exploration efforts toward finding new gas-well gas as distinguished from finding gas as a by-product in the search for oil." This ability may be confined to the larger companies which maintain the technical staffs skilled in making the necessary predictions. The smaller producers are in a less advantageous position. They may be relegated to the farmouts which the majors pass down to them or to operations in accord with their less scientific but sometimes financially rewarding hunches.

New gas discoveries are well said to be the life blood of the industry. The consumers may reasonably be required to pay the price needed to bring forth such discoveries. If an incentive price based on current costs is used for all gas, windfalls will be assured to many producers of old gas developed under lower historical costs and often found in association with oil.

The producers say that a single-price system based on current costs is required because revenues for current exploration and development must be internally generated from sales of gas from whatever source. The Commission rejected the argument. The question is not so much the source of the funds as it is the inducement to use available funds in the search for gas. The higher

price for new gas is intended to supply that inducement. Although the adequacy of the inducement can only be tested by future developments, we are not convinced that the refusal of the Commission to include the same inducement in the price of old gas, with the resulting likelihood of windfalls, was unreasonable.

Continental, Phillips, and others argue that the two-price system amounts to entrapment because of the possibility of reduction in price after financial commitments have been made. Although the Commission which announced the Permian Basin decision cannot bind a future Commission, we credit the Commission with good faith. The possibility of a change does not invalidate the rate method employed. When and if a reduction occurs, the argument of entrapment can be heard.

The division date of January 1, 1961, for the different prices of new gas-well gas and old gas-well gas is another subject of dispute. Here the Commission found as a fact that the appropriate date was the approximate time when directional drilling came to be used effectively. Under the evidence the selection of a division date was an administrative problem calling for the exercise of judgment. In making its choice the Commission acted within the evidence and within its powers. On rehearing, the Commission left open for future consideration the problem arising when new gas-well gas is developed from committed acreage. We assume that this problem will be met fairly when it comes to a head.

The two-price system is an outgrowth of directional drilling for gas. Its purpose is to assure a continued gas supply. The Commission frankly says that the adoption

of the system for the Permian Basin "should serve to furnish a practical test of whether in fact it will result in bringing forth additional supplies." We find no persuasive reason why the test should not be made.

7. *The Cost Information.*

In arriving at the Permian Basin rates the Commission used many sources of cost information. These included responses to questionnaires sent to producers, the Census of Mineral Industries for 1958, the Chase Manhattan Bank's 1961 Annual Analysis of the Petroleum Industry, the World Oil Magazine, the Oil and Gas Journal, the Joint Association Survey,[31] and others. The producers attack these sources on many and varied grounds. The range of objections runs from hearsay evidence through deprivation of right of cross-examination to denial of procedural due process. To take up each of these objections would increase the length of this opinion to encyclopedic dimensions.

From the information so obtained the parties, the staff, and the Commission make many computations and reach many results. The assumptions, allocations, formulae, equations, averages, means, and massive calculations may intrigue a mathematician or statistician but they have no attraction for us. We respectfully decline to be drawn into such a turmoil of numbers. We cannot in a few months unravel the snarl of statistics developed in the years of hearings. In our opinion the judicial process,

[31] This is a survey of a few producers conducted by the American Petroleum Institute, the IPAA, and the Mid-Continent Oil and Gas Association.

in cases such as this, should be confined to consideration of errors of law. We leave to the experts the selection of source material and the calculations to be made therefrom. Our concern is with the result.

8. *The Commission's Price Determinations.*

The Commission said that "costs must be a major factor in determining the area price." On the basis of current national statistics plus questionnaire data it determined the 1960 Mcf cost of new gas-well gas thus:

Exploration and Development Costs	
Dry Holes	1.42 cents
Other Exploratory Costs	1.59
Adjustment for Exploration in Excess of Production	1.11
Production Operating Expense	2.70
Net Liquid Credit	(3.10)
Regulatory Expense	.14
Depletion, Depreciation, and Amortization of Production Investment Costs	
Successful Well Costs	2.88
Lease Acquisition Costs	.76
Cost of Other Production Facilities	.31
Return of Production Investment[3] *(at 12%)*	5.21[32]
Return on Working Capital	.35
Subtotal	13.37
Royalty at 12½ percent	2.05
Production Taxes	1.01
Total	16.43

[32] This is computed as follows: The production investment is the sum of successful well costs, lease acquisition costs, and cost of other production facilities or a total of 3.95 cents. It is to be recouped over an average period of 10 years beginning an average of one year after investment. Accordingly, the return is allowed on an investment base 11 times the production investment of 3.95 cents per Mcf or 43.45 cents. 12% of this figure is 5.21 cents per Mcf.

The Commission rounded this figure off at 16.5 cents for the Texas production. Because the New Mexico figure is exclusive of taxes a reduction of one cent was made in the New Mexico price.

For the costing of flowing gas the Commission used historical data developed by the industry questionnaires. The results may be summarized thus:

Production operating expenses	1.75 cents
Depreciation, depletion and amortization	2.42
Return at 12%	4.99
Exploration and development	4.08
Regulatory expense	.14
	13.38
State production tax at 7%	1.01
	14.39[33]

This figure was rounded off at 14.5 cents for Texas and 13.5 cents for New Mexico. As a check on the method used the Commission back-trended the new gas-well gas figures and arrived at a 14.64-cent price.

The rates so established are subject to downward adjustment because of quality deficiencies and to both downward and upward adjustments on the basis of Btu content. The Commission disclaims any intent that the rate figures show producer costs. It says that the price of new gas-well gas is "geared" to costs derived from national statistics and the questionnaire data and that for flowing gas the "touchstone" is the historical price of Per-

[33] No separate item was included for royalty payments because costs were computed on ⅞ of actual volumes.

mian gas.[34] Other undefined and unidentified "factors" were taken into consideration.

9. *The Moratorium.*

The Commission implemented the price provisions of the decision in various ways. It imposed a moratorium on rate increases until January 1, 1968, "except in compliance with a specific order of the Commission for a rate as determined pursuant to said proceeding [AR61-1] or pursuant to later order of the Commission." The producers say this violates the Act because § 4 permits filings for rate increases. Section 4 must be read with other sections of the Act. Section 5 authorizes the Commission to determine the just and reasonable rate "to be thereafter observed and in force." Section 16 gives the Commission power to make such orders "as it may find necessary or appropriate to carry out the provisions of this act." In Callery the Court held that there was ample power under § 7(e) to impose a moratorium.[35] We believe that there is also ample power under §§ 5(a) and 16. The reasonableness of the exercise of the power is established by the need for price stability, the Commission's expressed willingness to reopen the proceedings to consider the propriety of changes, and the expiration date which is only about a year off.

10. *The Escalation Clauses.*

The Commission's order forbids the filing of rate changes in excess of applicable area rates when the con-

[34] In Opinion No. 468 the Commission said: "Nevertheless, we make clear that we do not confine ourselves to a cost calculation in determining just and reasonable rates."

[35] 382 U.S. 223, 228.

tractual, right thereto is based on indefinite escalation clauses not permitted by § 154.93(a), (b), and (c) of the Regulations under the Natural Gas Act. The producers say that this provision destroys existing contract rights. The Commission replies that it has not proscribed the clauses but merely the right to file under them. This is a thin distinction. In Pan American Petroleum Corporation v. Federal Power Commission, 10 Cir., 352 F.2d 241, 245, we upheld § 154.93 and pointed out that if a producer felt aggrieved thereby it could apply for a rule waiver under § 1.7(b) of the Commission's Rules of Practice and Procedure. We assume that a similar request could be made under the Permian order. When the request is made and rejected, the time will arrive for the consideration of the constitutional questions which the producers raise.

11. *The Commission's Fair Relationship Standard.*

In fixing the amounts of the area rates the Commission rejected the end result test and adopted a fair relationship standard. This appears clearly from Opinion No. 468-A. After disclaiming that it had made any finding that "jurisdictional revenues will equate to jurisdictional costs," the Commission said:

> "* * * we are convinced that the record fully justifies the Commission's judgment that the ceiling prices we have fixed 'provide a fair relationship between the aggregate price the consumer pays and the aggregate costs that the producers incur' in the Permian Basin."

Hope says that in the fixing of just and reasonable rates there must be a "balancing of the investor and the consumer interests."[36] It goes on to say that from the com-

[36] 320 U.S. 591, 603.

pany point of view the revenue must not only provide operation expense but also capital costs including "service on the debt and dividends on the stock"; and that the return to the equity owner must be commensurate "with returns on investments in other enterprises having corresponding risks" and "sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital."[37] The Court concluded the discussion of this problem with the observation that in Hope the "end result" could not be condemned as unjust and unreasonable.

In Colorado Interstate Gas Co. v. Federal Power Commission, 324 U.S. 581, 605, the Court, after referring to the Natural and Hope decisions said:

> "In those cases we held that the question for the courts when a rate order is challenged is whether the order viewed in its entirety and measured by its end results meets the requirements of the Act."

Also pertinent is the statement of the Court in Second Phillips that:[38]

> "To whatever extent the matter of costs may be a requisite element in rate regulation, we have no indication that the area method will fall short of statutory or constitutional standards. The Commission has stated in its opinion in this proceeding that the goal is to have rates based on the 'reasonable financial requirements of the industry' in each production area, * * * and we were advised at oral argument that composite cost-of-service data will be considered in the area rate proceedings."

Nothing in Second Phillips rejects the end result test of Hope. We believe that it applies here and that it is not

[37] Ibid.

[38] 373 U.S. 294, 309-310.

satisfied by a finding of fair relationship. Something more than mere semantics is involved. The determination of a fair rate from the standpoint of the consumers must depend to large extent on the informed judgment of the regulatory agency. In these proceedings no distributor, consumer interest, or consumer representative objects to the rates. They are accepted as just and reasonable.

From the standpoint of the producer the situation is different. It is entitled to recover its prudent operating expenses and capital costs with a return commensurate to the risk and sufficient to attract capital. These requirements must be tested against the record. They may not be brushed aside with a general finding of fair relationship. The Commission concedes that it did not equate jurisdictional costs to jurisdictional revenues. This is obvious because no determination was made of the jurisdictional revenues which the rates will produce.

12. *The High Cost Operator and the Small Producer.*

The Commission broke down the rates into components which it justified on averages based on national statistics and questionnaire data. We recognize that weighted averages and sifted averages are suspect.[39] We accept the principle that both the basic figures and the averages obtained therefrom must be typical and representative but we are not convinced that the Commission has misused its expertise in this technical field. It is self-evident that when average costs are used to compute ceiling prices, the high cost operator will be hurt and some low cost operators may receive windfalls. Probably

[39] See United States v. Abilene & Southern Railway Company, 265 U.S. 274, 291, and Interstate Commerce Commission v. Mechling, 330 U.S. 567, 583.

to a greater extent than in any other comparable segment of the national economy the element of chance can affect the success or failure of even the most prudent enterpreneur who engages in the natural-gas business.

The problem of the high cost operator is characteristic of group or area rate making. The Supreme Court upheld group rates in Acker v. United States, 298 U.S. 426, 431, and commented that "regulation cannot be frustrated by a requirement that the rate be made to compensate extravagant or unnecessary costs." In Tagg Brothers v. United States, D.C.Neb. 29 F.2d 750, 755, affirmed 280 U.S. 420, the court said that it was not necessary "to fix the rates so high that all agencies in the business would make money." Covington & Lexington Turnpike Road Company v. Sanford, 164 U.S. 578, 596, says that "the public cannot properly be subjected to unreasonable rates in order simply that stockholders may earn dividends."

The small producers, represented here by Big Chief Drilling Company, IPAA, Texas Independent Producers & Royalty Owners Association (TIPRO), J. C. Barnes, and others, join in the prediction that the Permian decision sounds the death knell of the small producers. Perhaps the flamboyant wildcatter must be replaced by the scientists of the industrial giants but the efforts of the boom-or-bust adventurers have contributed greatly to natural-gas discoveries. In its decision the Commission referred to the "smaller independent who traditionally drills much of the Permian exploratory acreage" and said that: "Consumers and the natural gas industry alike have a strong stake in the continuation of the exploration efforts of the thousands of small operators who con-

tribute a large share of the discoveries of new sources of gas."[40]

The Commission took note of the suggestions that small producers should be exempt from regulation.[41] It found that outright exemption was neither necessary nor desirable but said that the small producers needed "special treatment." To this end it defined a small producer as "a natural gas company selling jurisdictionally less than 10,000,000 Mcf annually on a nationwide basis." They were granted relief from various requirements of §§ 7 and 4 and were freed from rate adjustments because of quality differentials. In our opinion the classification is reasonable and within the Act.

The small producers do not seek complete exemption. Their attitude is that such relief would be illusory rather than real because the pipelines would not pay more for gas supplied by them than the price paid to the major companies. Their complaint is that the Commission did not give adequate consideration to small producers' costs.

Data covering the costs of Permian producers came from questionnaires which are classified as Appendix B and Appendix C. The Appendix B group was mandatory for producers with company-wide jurisdictional sales of over 10 million Mcf and optional for others.[42] The

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[40] Big Chief asserts that the small producers, although credited with only 20% of current production volumes, actually drill almost 40% of all successful gas wells and 50% of all successful exploratory gas wells.

[41] See statements of Justice Clark dissenting in Second Phillips, 373 U.S. 294, 329-330, and speaking for the Court in Federal Power Commission v. Hunt, 376 U.S. 515, 527.

[42] Appendix A pertained to well and drilling statistics. It is not pertinent here.

Appendix C questionnaires went to the small producers. Forty-two of the majors and 25 of the small producers answered Appendix B. The response to the Appendix C questionnaires was sporadic. The Commission used only the material supplied by the majors saying that the inclusion of the data supplied by the small producers "does not affect the results."

TIPRO and Big Chief both emphasize the testimony of a staff witness that the small producer questionnaire showed average unit costs 2 cents per Mcf higher than those of the majors. They argue that the end result standards must be applied not only to the entire group but to them as a group. The weakness of the argument is that once the whole group is split the process can be carried on until the regulation is back on an individual company basis.

We do not know the answer to the small producer problem. Superficially it seems unfair to fix ceiling prices for all producers, both large and small, on the basis of the costs of large producers only. The Commission rejected the small producer data because in its opinion the impact on the rate structure was de minimis. On the record presented, we are unwilling to say that this conclusion was erroneous as a matter of law.

In any regulation of the natural-gas industry on an area basis the high cost producers, be they majors or little fellows, are certain to be placed in a position less advantageous than that occupied by those whose good fortune and able management have supplied a lower cost base. We agree with the Commission that the expense items included in an individual cost-of-service are not

the measure of a confiscatory rate. A producer has no constitutional right to be reimbursed for dry-hole expenses.[43] Also it has no obligation to remain in business by replenishing the supplies of gas which form the basis of present obligations. Inability to continue exploration and development is not confiscation. We conclude that the impact of the Permian rates on the high cost producers does not destroy the area rate method.

13. *Gathering and Processing Costs.*

One subject of much discussion in the briefs is the allowance of the same rate for gas delivered at the tailgate of a processing plant and for gas delivered at the wellhead. Gathering lines cost money and have to be built and operated by someone. The Commission's position is that the revenues received for oil and oil products derived from condensation and processing return a profit which induces the building of the needed gathering lines and plants. Here again we reach the troublesome field of cost allocations between a regulated commodity, gas, and unregulated commodities, oil and liquified petroleum products.

Bass places particular emphasis on this phase of the case. It points to its extensive investments in gathering lines and plants and to its permanently certificated rate of 18 cents which, it says, the Commission has never specifically found unreasonable or discriminatory. The answer as we see it is that if area rates are proper no greater need exists for the consideration of the individual cost and revenue requirements in the case of Bass than

[43] Cf. Columbus Gas & Fuel Co. v. Public Utilities Commission of Ohio, 292 U.S. 398, 407.

in the case of the other producers. Perhaps in the future courts will have to explore the mysteries of allocations but we are not so inclined in this case. If in fact Bass and others similarly situated are confronted with confiscation, a way must be open for them to be heard.

14. *Special Exemptions.*

The Commission recognized that some provision must be made for special exemption from area rates. It said that when a producer's "out-of-pocket expenses in connection with the operation of a particular well are greater than the revenues under the applicable area price, he should be entitled to appropriate relief." It declined to "specify all of the special circumstances which may serve as a basis for exceptions to the area rate" and observed that failure to earn exploration and development expenses plus the allowed return does not amount to confiscation. In regard to the form of relief it held that "it may be sufficient to permit them to abandon their unprofitable sales."

We agree with the Commission that an escape clause cannot be used to convert an area rate into an individual company cost-of-service rate but an escape clause which does no more than prevent an unconstitutional confiscation amounts to nothing. None is needed for that purpose. The producers are right in saying that the Commission's exemption provisions are so vague and nebulous that neither they nor a court can determine what relief is being granted. Out-of-pocket expenses are not defined and we do not know what they include. If a producer's accounting is on a lease rather than well basis, the facts relating to a particular well might not be determinable.

It may be going too far to say categorically that individual producers should be permitted to show that the group costs are not typical or representative of their costs but in some instances that should be permitted. Conservation of gas is promoted if marginal wells are allowed to continue to produce but is discouraged if the same wells are shut down by a low price. Some producers furnish gathering facilities. Others sell at the wellhead and the pipelines pay for the gathering. Gathering costs are allowed pipelines. Perhaps in some instances they should be allowed to producers. An adequate savings clause should contain guidelines which if followed by an aggrieved producer will permit it to be heard promptly and to have a stay of the general rate order until its claim for exemption is decided. It is not enough to say in effect that confiscation will be prevented. Confiscation is an individual proposition and the individual is entitled to be heard. We are convinced that the Commission's special exemption provisions are inadequate.

15. *Quality Standards.*

The Commission provided for adjustments in the area rates to reflect quality differentials. It said that "the price of gas cannot be related to volume alone but must be related to units of energy free of impurities and sufficiently compressed to enter the pipeline." Standards were fixed for content of carbon dioxide, hydrogen sulphide, total sulphur, water, and other impurities; and the amount of delivery pressure was established. The applicable base area rate is adjusted downward by the net cost of processing the gas to bring it up to standard. Provision is made for both an upward and a downward adjustment of rate depending on the Btu content. Quality

statements are required to be filed together with an agreement by the seller and the buyer covering the cost of bringing the gas up to standard. If an agreement cannot be reached, each shall file a statement of its views on the processing costs.

About 90% of the flowing gas is substandard. We are cited to no figures on the similar percentage of new gas-well gas. The amount of the rate adjustments does not appear in the record because there was no evidence of the extent of quality differentials or of the processing costs of bringing the gas up to standard.[44] At oral argument various estimates were given as to the amount of rate reduction which would result from substandard quality. These were based on statements filed pursuant to the decision but after the record was closed. They ranged from .7 cents to 2.0 cents per Mcf. A spokesman for the Continental Group said that on 1960 volumes a revenue deficiency of some $12 million a year would result. The Commission response in this court to the Skelly motion for stay of the Commission's orders herein said that the reductions in applicable rates because of adjustments for quality standards are expected to result in a revenue reduction of about $10 million annually.[45]

The producers' argument that the imposition of quality standards violates procedural due process because of lack

[44] The Commission says in its brief that "appropriate price differentials or adjustments could not be made on the basis of the record."

[45] The statement was this: "It has been estimated that the reductions to the base rates alone will reduce the revenues from jurisdictional Permian sales by about $10 million annually. The adjustments for quality standards, which were substantially altered by Opinion 468-A * * * are expected to result in a further reduction of the same magnitude."

of notice need not be resolved at this time. We are remanding the case and now everyone has notice. The matter of the Btu adjustments presents a particular problem which was emphasized by Commissioner O'Connor in his dissent. The price goes down if the Btu content is below 1,000 and goes up if it is above 1,050. The producers say the adjustment upward should begin at 1,000. We do not understand the Commission's reasons for the gap. On remand this can be clarified.

16. *The Rate of Return.*

The Commission says that the impact of the quality adjustments is taken care of in the rate of return which is made generous on this account. It fixed a rate of return of 12% on production activities and held that such rate "protects gas consumers against excessive prices but it is not so low that it fails to respond to the needs of the industry." The principles applicable to the determination of an appropriate return are set forth in Bluefield Water Works & Improvement Co. v. Public Service Commission, 262 U.S. 679, 692-693. It "must be determined by the exercise of a fair and enlightened judgment, having regard to all relevant facts." The rates of a public utility should "permit it to earn a return on the value of the property * * * equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties" but the utility has no constitutional right to profits realized by "highly profitable enterprises or speculative ventures." The return should assure "confidence in the financial soundness of the utility" and be adequate under prudent management "to maintain and support its credit and en-

able it to raise the money necessary for the proper discharge of its public duties." The Hope decision[46] states the same basic principles.

The Commission recognized these controlling principles. The objections of the producers are to the point that the allowed rate of return is inadequate to enable the industry to attain the goals which the principles contemplate. At this time there is no need for us to go into the comparisons of the returns appropriate for producers as opposed to pipelines or to the financing methods employed by either. The fact is that by treating quality deductions as a risk rather than a cost the Commission has made it impossible to determine the amount of return with any degree of certainty. The difficulty is that the record does not disclose the amount of deductions.

A fair rate of return cannot be ascertained with mathematical certainty.[47] Pragmatic adjustments may be made by an agency within the ambit of its statutory authority.[48] A court must put great reliance on agency expertise in evaluating a rate of return but this does not mean that a court must accept the agency determination in blind faith. A producer is entitled to a higher rate of return than a pipeline because of the greater risk of the business. The Commission has here compounded the risk of discovery with the risk of substandard quality.

We believe that the price reductions to reflect quality deviations are an item of cost rather than an item of risk

[46] 320 U.S. 591, 603.

[47] Colorado Interstate Gas Co. v. Federal Power Commission, 10 Cir., 142 F.2d 943, 961-962, affirmed 324 U.S. 581.

[48] Federal Power Commission v. Natural Gas Pipeline Co., 315 U.S. 575, 586.

and should be directly reflected in the applicable base rates instead of hidden in a rate of return allowance. The amount of cost is the expense of bringing the quality up to standard. In the Permian Basin sound reason exists for this conclusion because of the known and substantial quality deficiencies particularly in flowing gas production. We find it hard to understand why a revenue deficiency in the estimated amount of $10 million annually should be classified as a risk and not a cost. A risk occurs as the result of unknown or unconsidered contingencies. In the Permian Basin it is known and considered that flowing gas falls short of pipeline standards. In any event, the lack of evidence as to quality deductions makes it impossible to determine whether the rate of return satisfies the Bluefield and Hope principles and we have no basis on which to appraise the allowance made by the Commission. We respect the expertise of the Commission but the conclusions reached by the use of expertise must accord with legal standards.

17. *Contract Limitations.*

The producers say that recovery of industry costs under the area rates is impossible because many of the existing contracts do not permit a producer to file for the flowing gas ceiling price of 14.5 cents. The Commission recognized that "there undoubtedly will be some contract prices lower than the area rate ceiling, as adjusted for quality." Some of the producers estimate the deficiency because of contract limitations to be $14.4 million in the test year of 1960. The Commission has estimated that a reduction of base rates alone will result in a revenue reduction of about $10 million annually.[49]

[49]See supra, note 45.

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It is elementary that gas prices are originally set by contract between the producer and the pipeline, that the producer may not raise the price unilaterally, and that any increase in price must be within contract terms unless the price is set so low as to affect the public interest. The Commission says that the producers are not entitled as a matter of right to collect contract rates that are higher than otherwise reasonable in order to offset other rates limited by contract to below maximum reasonable levels. Regulation does not guarantee an over-all profit;[50] relief from an unduly low rate may be given only if the rate is "so low as to adversely affect the public interest — as where it might impair the financial ability of the public utility to continue its service, cast upon other consumers an excessive burden, or be unduly discriminatory";[51] and a company's losses in one instance do not justify an illegal gain in another instance.[52] At the same time in such group procedures as the division of railroad rates the Interstate Commerce Commission, with court approval, has recognized that revenue from one source may balance that from another.[53]

Contract limitations are one of the facts of life for the natural-gas industry. They are the outgrowth of the days when gas, which had previously been vented, flared, or capped, became salable to the newly constructed inter-

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[50] Federal Power Commission v. Natural Gas Pipeline Co., 315 U.S. 575, 590.

[51] Federal Power Commission v. Sierra Pacific Power Co., 350 U.S. 348, 355.

[52] Federal Power Commission v. Tennessee Gas Transmission Co., 371 U.S. 145, 153.

[53] See New England Divisions Case, 261 U.S. 184.

state pipelines. The pipelines wanted long-term contracts and the producers wanted to sell their gas. Prices were low. With the phenomenal increase in the use of gas as an energy source the prices rose. The producers whose contracts either contained no escalation clauses or clauses of the type proscribed by the Commission were in a disadvantageous position. Even permissible escalations do not, in many instances, bring the 1960 price up to the area ceiling. In Second Phillips the Court upheld the termination of certain § 4(e) dockets on the Commission's finding that "the annual increase in revenue produced by these increased rates was substantially less than the deficit for the test year 1954."[54] The same situation exists here for many companies. We do not know whether it exists for the area producers as a group because no finding was made of revenue and requirements. The Supreme Court has said that losses in one instance do not justify illegal gains in another. To us this means that the contract limitations do not preclude the establishment of a just and reasonable area rate. The answer is provision for a minimum rate.

The Commission held that "the establishment of minimum rates in this case is in the public interest and that the price impact on the consumer will be de minimis." It established a minimum rate of 9 cents per Mcf for gas of standard pipeline quality. We believe that the controlling question is whether the proper revenue requirements of the area producers as a group can be satisfied with rates having the ceiling and the floor which the Commission has fixed. This cannot be answered because

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[54] 373 U.S. 294, 305.

the financial impact of the quality deductions is not ascertainable from the record.

18. *Refunds.*

The revenue deficiency argument of the producers leads directly to the refund issue. The Commission required "appropriate refunds in the case of rates which are the subject of proceedings under Section 4(e) of the Act, and have thus been collected subject to an obligation to refund amounts collected in excess of the just and reasonable rates as here determined." Procedures to accomplish this result were set up in detail.

The producers say that these individual company refunds are not proper because of the revenue deficiency of the industry. They say that in the test year of 1960 the producers in the area failed to meet their revenue requirements by $14.4 million and they estimate the refunds for that year under the Commission decision to approximate $6 million.

The Examiner held that refunds should be ordered only to the extent that over-all industry revenues exceed over-all industry expenditures in a given year. The Commission said that this theory was unworkable because it would result in inequities among both the buyers and the producers and because of "insurmountable" administrative difficulties. We are at a loss to understand how refund obligations, which might come into existence under the Examiner's approach, would be divided among the producers.

We see no escape from the requirement that refunds be on an individual company basis and on a schedule by

schedule basis. As we understand Federal Power Commission v. Tennessee Gas Transmission Co., 371 U.S. 145, 153, refunds are appropriate for each excessive rate regardless of over-all revenues. The Commission has required refunds only on § 4(e) rate increases above the applicable area ceiling. If a producer claims that the refunds required of it are confiscatory or harmful to the public interest, it must have an opportunity to petition for special relief. A similar opportunity must be afforded if a producer can show that a refund is required for collections at or below the "last clean rate."[55] An adequate special exemption clause can take care of such situations.

19. *The End Result Test.*

This brings us back to the end result test. The Continental Group, which includes many large producers and major integrated oil companies and which is supported by Phillips, presents alternative arguments. The first is economic. It is said that regulation under the Act must be consistent with the economic characteristics of the industry; that this requires the establishment of market prices based on contracts; that a cost-based system of regulatory rates does not recognize the responsiveness of the gas supply to gas prices; and that a producer does not explore on the expectation of a return of its cost plus a return on its investment but on the hope of getting back many times what it expends as a reward for its gambler's risk. No doubt these are the economic facts of the industry.

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[55] By "last clean rate" is meant the last rate in effect pursuant to a permanent certificate not subject to any refund obligation.

The divorce of commodity value from costs was suggested by Justice Jackson in his dissent in Hope. He commented that a producer would have difficulty showing the invalidity of a fixed commodity value so long as it voluntarily continued to sell its product in interstate commerce.[56] One difficulty with this suggestion is that once the gas is committed no withdrawal from interstate movement is possible without Commission approval.[57] A producer can stop exploration and development if it is dissatisfied with price but the interstate sales go on with a continuing impact of cost on price and of price on exploration and development. In any event the majority rejected the proposal and held that under the just and reasonable standard of the Act a regulated company is entitled to revenue for operating expenses and capital costs and to a return "commensurate with returns on investments in other enterprises having corresponding risks."[58] These standards cannot be met without consideration of costs and revenues. In our opinion the Hope construction of the statutory standard casts serious doubts on the validity of the adoption of a contract-based commodity value.

The alternate argument of the Continental Group is that if the rates are to be determined on a composite cost-of-service basis, the revenue requirements of the industry must be found and rates fixed to meet those requirements. In Second Phillips the Court particularly noted the assurance of the Commission that "composite cost-of-service

[56] 320 U.S. 591, 652.

[57] Section 7(b) of the Act. See also Sunray Mid-Continent Oil Co. v. Federal Power Commission, 364 U.S. 137, 156.

[58] 320 U.S. 591, 603.

data will be considered in the area rate proceedings."[59] Consideration of such data does not eliminate consideration of other factors. At the same time Second Phillips did not reject the end result test of Hope. Instead it quoted a portion of that opinion which said among other things that "it is the result reached not the method employed which is controlling."[60]

The Commission rejected both alternatives of the Continental Group. It said that commodity value established by contracts may not be used because of the absence of effective competition; and it emphasized that it took into consideration factors other than costs. The record does not disclose what these other factors were but they must have had some economic basis. The Commission held that its ceiling prices provided a "fair relationship" between consumer prices and producer costs. Fair relationship is pertinent but it is only part of the end result test. We do not know the producers' costs or revenue requirements. We do not know the economic factors which either require or permit departure from costs and revenues. The end result test is not satisfied by a reliance on unknowns.

We have accepted the Commission's conclusion that contract rates should not be used. The trouble is that the Commission decision rides two horses and we have no way of knowing the outcome of the race. It uses composite cost-of-service evidence, engrafts economic factors on top, and comes out with a rate which it justifies on a fair relationship basis. We have the problem of how in such circumstances a court can determine whether the

[59] 373 U.S. 294, 310.

[60] Id. at 309.

just and reasonable standard of §§ 4 and 5 has been met. The answer is not found in the record before us.

The facts sustaining the conclusion of fair relationship must be found. The Commission did not make those findings and indeed it could not have done so because of the failure of the record to disclose the revenue impact of the adjustments in area rates to reflect quality differentials. Whether rate reductions because of quality deficiencies are a risk or a cost, the answer comes out the same. If they are a risk, we do not know the rate of return. If they are a cost, we do not know whether the revenue received will equal the reasonable revenue requirements. We believe that under Hope, and under Second Phillips, the area producers, as a group, are entitled to recover their prudent operating expenses and capital costs with a return commensurate to the risk and sufficient to attract capital. Satisfaction of this requirement must appear through appropriate findings based on substantial evidence. These cannot be made on the record presented. The decision of the Commission is not saved by the special exemption provisions which we find to be insufficient and unsatisfactory.

Rate making under the Act has produced a superabundance of delay and litigation. Much gas has moved through the pipelines since the First Phillips decision. We wonder if the time has not come for the establishment of a better rapport among the Commission, the consumers, the distributors, the pipelines, and the producers. Some practical means of resolving the economic and legal issues is highly desirable. The Commission has approved many settlements. The use of this procedure may well

be explored further in an effort to obtain a true "balancing of the investor and the consumer interests."[61]

One point remains to be mentioned. Eleven motions for leave to adduce additional evidence were filed with us by various producers. We deferred all to the hearing on the merits. In view of the disposition which we make of the cases we see no reasons to explore evidentiary problems which may arise on remand. The Commission will hold such additional hearings as are needed to determine the effect of the quality adjustments, and to determine the group revenues and the group [illegible] requirements. It will make appropriate findings on those matters. The order based thereon shall contain an adequate provision for special exemptions. We decline to make advance rulings on the procedures to be followed or on the evidence to be received.

The motions to adduce additional evidence are severally denied. The petitions to review are severally granted and the cases are all remanded to the Commission for further proceedings consistent with this opinion.

---

[61] 320 U.S. 591, 603.

APPENDIX B

Rates And Charges; Schedules; Suspension Of New Rates

Sec. 4. (a) All rates and charges made, demanded, or received by any natural-gas company for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges, shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful.

(b) No natural-gas company shall, with respect to any transportation or sale of natural gas subject to the jurisdiction of the Commission, (1) make or grant any undue preference or advantage to any person or subject any person to any undue prejudice or disadvantage, or (2) maintain any unreasonable difference in rates, charges, service, facilities, or in any other respect, either as between localities or as between classes of service.

(c) Under such rules and regulations as the Commission may prescribe, every natural-gas company shall file with the Commission, within such time (not less than sixty days from the date this act takes effect) and in such form as the Commission may designate, and shall keep open in convenient form and place for public inspection, schedules showing all rates and charges for any transportation or sale subject to the jurisdiction of the Commission, and the classifications, practices, and regulations affecting such rates and charges, together with all contracts which in any manner affect or relate to such rates, charges, classifications, and services.

(d) Unless the Commission otherwise orders, no change shall be made by any natural-gas company in any such rate, charge, classification, or service, or in any rule, regulations, or contract relating thereto, except after thirty days' notice to the Commission and to the public. Such notice shall be given by filing with the Commission and keeping open for public inspection new schedules stating plainly the change or changes to be made in the schedule or schedules then in force and the time when the change or changes will go into effect. The Commission, for good cause shown, may allow changes to take effect without requiring the thirty days' notice herein provided for by an order specifying the changes so to be made and the time when they shall take effect and the manner in which they shall be filed and published.

(e) Whenever any such new schedule is filed the Commission shall have authority, either upon complaint of any State, municipality, State commission, or gas distributing company or upon its own initiative without complaint, at once, and if it so orders, without answer or formal pleading by the natural-gas company, but upon reasonable notice, to enter upon a hearing concerning the lawfulness of such rate, charge, classification, or service; and, pending such hearing and the decision thereon, the Commission, upon filing with such schedules and delivering to the natural-gas company affected thereby a statement in writing of its reasons for such suspension, may suspend the operation of such schedule and defer the use of such rate, charge, classification, or service, but not for a longer period than five months beyond the time when it would otherwise go into

effect; and after full hearings either completed before or after the rate, charge, classification, or service goes into effect, the Commission may make such orders with reference thereto as would be proper in a proceeding initiated after it had become effective. If the proceeding has not been concluded and an order made at the expiration of the suspension period, on motion of the natural-gas company making the filing, the proposed change of rate, charge, classification, or service shall go into effect. Where increased rates or charges are thus made effective, the Commission may, by order, require the natural-gas company to furnish a bond, to be approved by the Commission, to refund any amounts ordered by the Commission, to keep accurate accounts in detail of all amounts received by reason of such increase, specifying by whom and in whose behalf such amounts were paid, and, upon completion of the hearing and decision, to order such natural-gas company to refund, with interest, the portion of such increased rates or charges by its decision found not justified. At any hearing involving a rate or charge sought to be increased, the burden of proof to show that the increased rate or charge is just and reasonable shall be upon the natural-gas company, and the Commission shall give to the hearing and decision of such questions preference over other questions pending before it and decide the same as speedily as possible. [52 Stat. 822 (1938); 76 Stat. 72 (1962); 15 U.S.C. § 717c]

Fixing Rate And Charges; Determination Of Cost Of Production Or Transportation

SEC. 5. (a) Whenever the Commission, after a hearing had upon its own motion or upon complaint of any

State, municipality, State commission, or gas distributing company, shall find that any rate, charge, or classification demanded, observed, charged, or collected by any natural-gas company in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order: *Provided, however,* That the Commission shall have no power to order any increase in any rate contained in the currently effective schedule of such natural-gas company on file with the Commission, unless such increase is in accordance with a new schedule filed by such natural-gas company; but the Commission may order a decrease where existing rates are unjust, unduly discriminatory, preferential, otherwise unlawful, or are not the lowest reasonable rates.

(b) The Commission upon its own motion, or upon the request of any State commission, whenever it can do so without prejudice to the efficient and proper conduct of its affairs, may investigate and determine the cost of the production or transportation of natural gas by a natural-gas company in cases where the Commission has no authority to establish a rate governing the transportation or sale of such natural gas. [52 Stat. 823 (1938); 15 U.S.C. § 717d]

Administration Powers of Commission; Rules, Regulations, and Orders

Sec. 16. The Commission shall have power to perform any and all acts, and to prescribe, issue, make, amend, and rescind such orders, rules and regulations as it may find necessary or appropriate to carry out the provisions of this act. Among other things, such rules and regulations may define accounting, technical, and trade terms used in this act; and may prescribe the form or forms of all statements, declarations, applications, and reports to be filed with the Commission, the information which they shall contain, and the time within which they shall be filed. Unless a different date is specified therein, rules and regulations of the Commission shall be effective thirty days after publication in the manner which the Commission shall prescribe. Orders of the Commission shall be effective on the date and in the manner which the Commission shall prescribe. For the purposes of its rules and regulations, the Commission may classify persons and matters within its jurisdiction and prescribe different requirements for different classes of persons or matters. All rules and regulations of the Commission shall be filed with its secretary and shall be kept open in convenient form for public inspection and examination during reasonable business hours. [52 Stat. 830 (1938); 15 U.S.C. § 717o]

Rehearing; Court Review Of Orders

Sec. 19. (a) Any person, State, municipality, or State commission aggrieved by an order issued by the Commission in a proceeding under this act to which such

person, State, municipality, or State commission is a party may apply for a rehearing within thirty days after the issuance of such order. The application for rehearing shall set forth specifically the ground or grounds upon which such application is based. Upon such application the Commission shall have power to grant or deny rehearing or to abrogate or modify its order without further hearing. Unless the Commission acts upon the application for rehearing within thirty days after it is filed, such application may be deemed to have been denied. No proceeding to review any order of the Commission shall be brought by any person unless such person shall have made application to the Commission for a rehearing thereon. Until the record in a proceeding shall have been filed in a court of appeals, as provided in subsection (b), the Commission may at any time, upon reasonable notice and in such manner as it shall deem proper, modify or set aside, in whole or in part, any finding or order made or issued by it under the provisions of this Act.

(b) Any party to a proceeding under this act aggrieved by an order issued by the Commission in such proceeding may obtain a review of such order in the circuit court of appeals of the United States for any circuit wherein the natural-gas company to which the order relates is located or has its principal place of business, or in the United States Court of Appeals for the District of Columbia, by filing in such court, within sixty days after the order of the Commission upon the application for rehearing, a written petition praying that the order of the Commission be modified or set aside in whole or in part. A copy of such petition shall

forthwith be transmitted by the clerk of the court to any member of the Commission and thereupon the Commission shall file with the court the record upon which the order complained of was entered, as provided in section 2112 of title 28, United States Code. Upon the filing of such petition such court shall have jurisdiction, which upon the filing of the record with it shall be exclusive, to affirm, modify, or set aside such order in whole or in part. No objection to the order of the Commission shall be considered by the court unless such objection shall have been urged before the Commission in the application for rehearing unless there is reasonable ground for failure so to do. The finding of the Commission as to the facts, if supported by substantial evidence, shall be conclusive. If any party shall apply to the court for leave to adduce additional evidence, and shall show to the satisfaction of the court that such additional evidence is material and that there were reasonable grounds for failure to adduce such evidence in the proceedings before the Commission, the court may order such additional evidence to be taken before the Commission and to be adduced upon the hearing in such manner and upon such terms and conditions as to the court may seem proper. The Commission may modify its findings as to the facts by reason of the additional evidence so taken, and it shall file with the court such modified or new findings, which if supported by substantial evidence, shall be conclusive, and its recommendation, if any, for the modification or setting aside of the original order. The judgment and decree of the court, affirming, modifying, or setting aside, in whole or in part, any such order of the Commission, shall be final, subject to review by the Supreme Court of

the United States upon certiorari or certification as provided in [former] sections 239 and 240 of the Judicial Code, as amended (U.S.C., title 28, sec. 1254).

(c) The filing of an application for rehearing under subsection (a) shall not, unless specifically ordered by the Commission, operate as a stay of the Commission's order. The commencement of proceedings under subsection (b) of this section shall not, unless specifically ordered by the court, operate as a stay of the Commission's order. [52 Stat. 831 (1938); 15 U.S.C. § 717r]

SUPPLEMENTAL TO PETITION FOR A WRIT OF CERTIORARI

MAY 4 1967

In the Supreme Court of the United States

OCTOBER TERM, 1966

Office-Supreme Court, U.S.
FILED
JUN 12 1967
JOHN F. DAVIS, CLERK

No. [redacted] 100

PEOPLE OF THE STATE OF CALIFORNIA
and PUBLIC UTILITIES COMMISSION OF
THE STATE OF CALIFORNIA,

Petitioners,

vs.

SKELLY OIL COMPANY,
PHILLIPS PETROLEUM COMPANY,
WARREN PETROLEUM CORPORATION,
MOBIL OIL CORPORATION (formerly
Socony Mobil Oil Company, Inc.),
PAN AMERICAN PETROLEUM CORPORATION,
NORTHERN NATURAL GAS PRODUCING COMPANY,

[*Continued on Inside Cover*]

Motion for Leave to File Supplement to Petition for a Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

and

Supplement to Petition for a Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

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May 2, 1967

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[*Continued from Cover*]

STANDARD OIL COMPANY OF TEXAS, a Division of
Chevron Oil Company,
TEXACO INC.,
HUNT OIL COMPANY jointly with
H. L. Hunt,
Lamar Hunt,
N. B. Hunt,
W. H. Hunt,
Secure Trusts,
Caroline and Loyd B. Sands,
Caroline Hunt Trust Estate,
Lyda Hunt-Caroline Trusts,
Lyda Hunt-Bunker Trusts,
Lyda Hunt-Lamar Trusts,
Lyda Hunt-Herbert Trusts,
Lyda Hunt-Margaret Trusts
(formerly Estate of Lyda Bunker Hunt, Deceased),
Hunt Industries
(formerly Estate of Lyda Bunker Hunt, Deceased), and
Placid Oil Company,
HUMBLE OIL & REFINING COMPANY,
SHELL OIL COMPANY,
THE ATLANTIC RICHFIELD COMPANY (formerly
The Atlantic Refining Company) jointly with
Dorchester Gas Producing Company,
Southland Royalty Company, and
Westates Petroleum Company,
CONTINENTAL OIL COMPANY jointly with
Sunray DX Oil Company,
Sinclair Oil & Gas Company,
Cabot Corporation,
Sohio Petroleum Company,
Joseph E. Seagram & Sons, Inc.,
Joseph E. Seagram & Sons dba
Texas Pacific Oil Company,
Gulf Oil Corporation,
Murphy Oil Corporation,
The Nueces Company,
Samedan Oil Corporation,

[*Continued from Inside Cover*]

Cities Service Oil Company
(formerly Cities Service Petroleum Corporation),
Cities Service Production Company
(now merged with Cities Service Oil Company),
Columbian Fuel Corporation,
Amerada Petroleum Corporation,
Union Oil Company of California and as successor to
The Pure Oil Company,
Tidewater Oil Company,
Reef Corporation, and
William A. & Edward R. Hudson, Joint Operators,
MARATHON OIL COMPANY,
SUN OIL COMPANY,
INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA,
THE BRITISH-AMERICAN OIL PRODUCING COMPANY,
UNION TEXAS PETROLEUM, a Division of
Allied Chemical Corporation,
MIDHURST OIL CORPORATION,
THE SUPERIOR OIL COMPANY,
PERRY R. BASS jointly with
Panther City Investment Co.,
Bass Bros. Enterprise, Inc.,
Perry R. Bass, Incorporated, and
Richardson Oils, Inc.,
COLUMBIAN CARBON COMPANY jointly with
Coltexo Corporation,
THE STATE OF TEXAS,
BIG CHIEF DRILLING COMPANY jointly with
King-Stevenson Oil Co., Inc., and
Service Drilling Company,
TEXAS INDEPENDENT PRODUCERS & ROYALTY OWNERS
ASSOCIATION jointly with
West Central Texas Oil and Gas Association,
STATE OF NEW MEXICO,
GULF OIL CORPORATION, and
J. C. BARNES, *et al.*, *Respondents.*

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In the Supreme Court of the United States

OCTOBER TERM, 1966

No. 1293

PEOPLE OF THE STATE OF CALIFORNIA and PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, *Petitioners,*

vs.

SKELLY OIL COMPANY, et al., *Respondents.*

Motion for Leave to File Supplement to Petition for a Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

The petitioners in the above-entitled proceeding, the People of the State of California and the Public Utilities Commission of the State of California, pursuant to Rule 35 of the Revised Rules of the Supreme Court of the United States, respectfully move for leave to file this Supplement to their Petition for a Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit. Said Petition for a Writ of Certiorari was filed in this Court on April 19, 1967, Docket No. 1293, October Term, 1966.

This motion is necessitated by the action of the Court of Appeals. Petitioners stated at pages 2 and 3 of their Petition for a Writ of Certiorari that several petitions for

rehearing were pending in the court below. (Between March 6 and March 10, 1967, petitions for rehearing were filed by the following respondents:

Shell Oil Company and Phillips Petroleum Company in Docket Nos. 8409 and 8489;

Warren Petroleum Corporation, Gulf Oil Corporation, The British-American Oil Producing Company, Humble Oil & Refining Company, Cities Service Oil Company, Cities Service Production Company, Coltexo Corporation, Columbian Fuel Corporation, and Columbian Carbon Company in Docket Nos. 8440, 8493, 8534, 8497, 8488, 8493, and 8517;

Standard Oil Company of Texas in Docket No. 8479;

Mobil Oil Corporation (formerly Socony Mobil Oil Co., Inc.) and Northern Natural Gas Producing Company in Docket Nos. 8455, 8460, and 8588;

Pan American Petroleum Corporation and Sinclair Oil & Gas Company in Docket Nos. 8458 and 8493;

Texaco Inc., Amerada Petroleum Corporation, Atlantic Richfield Company, Southland Royalty Company, Westates Petroleum Company, Dorchester Gas Producing Company, Sunray DX Oil Company, Marathon Oil Company, Sohio Petroleum Company, and Tidewater Oil Company in Docket Nos. 8482, 8541, 8493, 8542, 8490, 8540, and 8494.)

On April 18, 1967, the Court of Appeals granted these petitions for rehearing and issued its Per Curiam Opinion and Order on Rehearing. The Court of Appeals reversed its original opinion on two important matters. The object of this motion is to provide this Court with a printed copy of the Per Curiam Opinion and Order on Rehearing, and to present petitioners' additional questions for review which result from said Opinion and Order on Rehearing, and to state their reasons, with respect to such additional questions, for granting their petition for a writ of certiorari.

The Per Curiam Opinion and Order on Rehearing of the court below adversely affects petitioners respecting whether the Federal Power Commission may prospectively constitute its determined just and reasonable area rates as the initial price for certification of subsequent sales in the area under Section 7 of the Natural Gas Act, and respecting whether the Federal Power Commission may require in an area rate proceeding refunds of rates collected subject to refund under Section 4 of the Act on a rate schedule-by-rate schedule basis. Petitioners submit that the Per Curiam Opinion and Order on Rehearing is erroneous and unlawful, and that it raises additional questions of law which should be reviewed by this Court.

Therefore, petitioners respectfully pray that this motion be granted in order that said Per Curiam Opinion and Order on Rehearing and petitioners' objections to it may be added to petitioners' petition for a writ of certiorari.

Respectfully submitted,

/s/ Mary Moran Pajalich
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May 2, 1967

In the Supreme Court of the United States

OCTOBER TERM, 1966

No. 1293

PEOPLE OF THE STATE OF CALIFORNIA and PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA,
Petitioners,

vs.

SKELLY OIL COMPANY, *et al.*,
Respondents.

Supplement to Petition for a Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

INTRODUCTORY STATEMENT

As indicated at pages 2 and 3 of their Petition for a Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit,[1] petitioners, People of the State of California and Public Utilities Commission of the State of California (California), advised this Court that certain

1. Filed in this Court on April 19, 1967, Docket No. 1293, October Term, 1966.

respondents had filed petitions for rehearing before the Court of Appeals and that this Court would be advised of the determination of these petitions by the Court of Appeals as soon as possible.

The judgment of the Court of Appeals entered on January 20, 1967, is printed in Supplemental Appendix A.

On April 18, 1967, the Court of Appeals issued a *per curiam* opinion and order on rehearing which is not as yet reported. This *per curiam* opinion and order on rehearing is printed as Supplemental Appendix B.

ADDITIONAL QUESTIONS PRESENTED

1. Where the Federal Power Commission has determined just and reasonable area rates under Sections 4 and 5 of the Natural Gas Act, may the Commission find that such area rates prospectively constitute the initial price for certificating sales in the area under Section 7 of the Act?[2]

2. Where the Federal Power Commission has determined just and reasonable area rates, must area revenues exceed the allowable area cost of service before refunds of contract rates collected subject to refund under Section 4 of the Act may be ordered?

ADDITIONAL STATUTE INVOLVED

Due to the Court of Appeals' *per curiam* opinion and order on rehearing, which involves certificate applications under Section 7 of the Natural Gas Act, petitioners hereby set forth the provisions of Section 7, 15 U.S.C. Section 717f, in Supplemental Appendix C.

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2. Although the court below did not decide this question inasmuch as it remanded the case for further proceeding before the Commission with respect to the validity of the area rates, petitioners take the position that such area rates are valid and, therefore, urge this Court, if it concludes that such rates are valid, to decide this question at this time.

ADDITIONAL STATEMENT OF THE CASE

The Court of Appeals' *per curiam* opinion and order on rehearing apparently remands the Federal Power Commission's (Commission) certificate order (J.A. 827d-838d) issued concurrently with Opinion No. 468. The concurrent certificate order concerned four separate applications under Section 7 of the Natural Gas Act for certificates of public convenience and necessity to sell gas produced in the area.[3] These applications were consolidated with the area rate proceeding and in the meantime temporary certificates were granted to all four applicants. By its concurrent certificate order the Commission granted permanent certificates to these applicants, but it conditioned them to an initial price no higher than the applicable area rates. Upon petition for rehearing by one of the applicants, Texaco Inc., in Docket No. CI61-879, the Court of Appeals in its *per curiam* opinion has remanded the concurrent certificate order in the Texaco Inc. matter, Docket No. CI61-879. The court probably intended its opinion and order to incluude remand of the Commission's entire certificate order. In any event, the lower court expressly declined to either approve or disapprove the Commission's action to constitute the area rates determined under Sections 4 and 5 of the Act to be the initial price required by public convenience and necessity in certificate applications under Section 7. By its action the court refused to approve the position adopted by the Commission.

Furthermore, the Court of Appeals' *per curiam* opinion and order reverses its original decision with regard to refunds of rates collected subject to refund under Section 4(e)

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3. The four applications consolidated are: North Central Oil Corporation (Operator), *et al.*, Docket No. CI60-435; Socony Mobil Oil Company, Inc., Docket No. CI61-34; Robert T. Brown (Operator), *et al.*, Docket No. CI61-733; Texaco Inc., Docket No. CI61-879.

of the Act. The court below now adopts the position of the producers and holds that refunds on a rate schedule-by-rate schedule basis would be inconsistent with its conclusion that in an area rate proceeding group revenues must equal the group revenue requirement. Therefore, the court prohibits any refunds when there is a group revenue deficiency. The court directs that refunds may be ordered "on some equitable contract-by-contract basis" when group revenues exceed the group revenue requirements. In its change of position on this matter the court withdraws its reliance upon *Federal Power Commission v. Tennessee Gas Transmission Company*, 371 U.S. 145 (1962), and relies upon *Second Phillips*.[4]

ADDITIONAL REASONS FOR GRANTING THE WRIT

A. The Court Below Has Reversed the Commission's Concurrent Certificate Order Without Giving Any Reasons

The Court of Appeals has remanded the Commission's concurrent certificate order on the ground that since this order establishes the area rate, which the court has reversed and remanded, as the proper initial contract price to be permitted in the consolidated certificate proceedings, the certificate order also must be remanded.

California submits that this action reverses the Commission's determination in Opinion No. 468 that the just and reasonable area rates would constitute the intitial certificate price, less possible quality deductions, in subsequent Section 7 proceedings. After stating in the certificate order that the only issue involved is the level at which the initial price should be set, the Commission relies on its determination in Opinion No. 468 (J.A. 668d) to prescribe the area

4. *Wisconsin v. Federal Power Commission*, 373 U.S. 294 (1963).

rates as the proper initial price in subsequent certificate proceedings. (J.A. 827d-828d.) Despite the court's disclaimer that it has not spoken on the question whether the area rates may be constituted as initial certificate prices, the result of the court's action is to reverse the Commission's determination on this question without giving any reasons. The court has actually decided this question adversely to the Commission. California submits that the court should have affirmed the Commission's determination even though the correct figure for the initial price would not be known due to the remand of its area rate determination.

The court's action in reversing the Commission's determination on this issue without any discussion can only result in further delay in the development of area rate making. Such action is contrary to the primary purpose of the Act, which is to protect consumers. *Atlantic Refining Company, et al. v. Public Service Commission of New York,* 360 U.S. 378 (1959). If the position of the court below prevails, its opinion on this issue would be required before further judicial review would be possible. California submits that this issue is properly before this Court in that the Commission expressed its view on it in Opinion No. 468 and in its concurrent certificate order. California urges that this Court review this issue and affirm the Commission's determination.

B. The Reversal by the Court Below of Its Original Position on the Refund Question Is Erroneous

The court below has completely reversed itself on the question of the proper basis for refunds in an area rate proceeding. The court originally said that it "saw no escape that refunds be on an individual company basis and on a schedule by schedule basis" and that if confiscation would result or the public interest would be harmed by any refund

obligation the answer was an adequate special relief provision (App. A to the Petition, p. 426-27). Now the court says that refunds must be made on an industry area wide basis, thereby permitting refunds only if group area revenues exceed group area revenue requirements.

California submits that the lower court's new position is unlawful. The court's conclusion that *Federal Power Commission v. Tennessee Gas Transmission Company,* 371 U.S. 145 (1962), is no longer applicable because it dealt with zone rates is grossly inaccurate. That case announced fundamental and permanent principles regarding refunds under Section 4(e) of the Natural Gas Act, and it cannot be brushed aside on its facts. 371 U.S. 145, 152-3. The lower court would permit individual producers who have assumed the hazards involved in the Section 4 procedure to retain any illegal gain (i.e., that portion of rates which exceed the Commission's just and reasonable area rates and which were collected subject to refund) in the name of balancing group revenues with group revenue requirements. Such a result leaves producers in the best of all worlds—refund determinations made on a group basis and special relief determined on an individual basis. In addition, such a result is contrary to this Court's firm statement that regulation does not guarantee a profit. *Federal Power Commission v. Natural Gas Pipeline Company,* 315 U.S. 575, 590 (1942). It also violates this Court's decision in *Hope*[5] by permitting an end result totally unfair to consumers.

Likewise, the lower court's reliance upon *Second Phillips* to justify its change of position is misplaced. The Commission decision in that case did not hold that increased rates collected subject to refund, which were higher than the subsequently determined just and reasonable rate, cannot

5. *Federal Power Commission v. Hope Natural Gas Company,* 320 U.S. 591 (1944).

be refunded because company overall costs exceed revenues for the test year. This Court expressly recognized in *Second Phillips* that the Commission had not made any determination of just and reasonable rates for the company because the Commission had found the individual company cost-of-service method was not adequate for producers. 373 U.S. 294, 306 n. 15. This Court approved the Commission's termination of a limited number of consolidated rate increase proceedings for locked-in periods on the ground that it was not worth the time and cost to determine reasonable rates for certain past periods, and then determine the refunds required.

CONCLUSION

For the reasons stated above, petitioners submit that the *per curiam* opinion and order of the Court of Appeals is erroneous, and petitioners respectfully pray that a petition for a writ of certiorari issue to the Court of Appeals for the Tenth Circuit.

Respectfully submitted,

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May 2, 1967

(Supplemental Appendices Follow)

Supplemental Appendix A

JUDGMENT*

Thirteenth Day, January Term,
Friday, January 20th, 1967.

Before Honorable David T. Lewis,
Honorable Jean S. Breitenstein and
Honorable Delmas C. Hill,
Circuit Judges.

No. 8385

SKELLY OIL COMPANY,
Petitioner,

v.

FEDERAL POWER COMMISSION,
Respondent.

ON PETITION TO REVIEW AN ORDER OF THE FEDERAL POWER COMMISSION

This cause came on to be heard on petition to review an order of the Federal Power Commission and motion to adduce additional evidence and was argued by counsel.

On consideration whereof, it is ordered by this court that the motion to adduce additional evidence is hereby denied. The petition to review is granted and the case is remanded to the Commission for further proceedings consistent with the opinion of the court.

*An identical judgment was entered in each of the thirty-two docketed proceedings in the Court of Appeals.

Supplemental Appendix B

UNITED STATES COURT OF APPEALS TENTH CIRCUIT

Nos. 8385 etc., March Term, 1967

Filed—United States Court of Appeals Tenth Circuit
Apr 18 1967
William L. Whittaker, Clerk

SKELLY OIL COMPANY, et al.,
Petitioners,

v.

FEDERAL POWER COMMISSION,
Respondent.

ON REHEARING.

PER CURIAM.

Texaco Inc. asserts that the opinion is not clear as to the disposition of its Docket No. C161-879 [*sic*] in which, by an order separate and apart from Opinions Nos. 468 and 468-A and their accompanying orders, a § 7 certificate was issued at a rate of 14.5 cents less quality deductions. This separate order shows that the Commission treated the area rate as the in-line rate for § 7 certificates.

The order on this docket was lost in the mass of material presented to us. No party made a point of it. We have reconsidered the Texaco petition for review and have concluded that it is sufficiently broad to cover such order. It should receive the same treatment as the § 4 and § 5 pro-

ceedings. Accordingly, the remand includes the separate order entered in Docket No. C161-879 [*sic*].

We note that in its disposition of this particular docket the Commission took the position that an established area rate automatically becomes the in-line rate for a § 7 proceeding. The same position was taken by the Commission in its Opinion No. 484 which we are today reversing by our decision in Nos. 8723 etc.—Phillips Petroleum Company, et al., v. Federal Power Commission, ... F.2d ..... We there hold that in a § 7 application heard by the Commission after its Permian decision the adoption of the area rate as an in-line rate must fall because we have rejected the area rate. We do not there, and we do not here, express either approval or disapproval of the principle that an area rate established in a § 5 proceeding automatically becomes an in-line rate for a § 7 proceeding. The validity of such a principle may be affected by the final determination of the validity of the Permian Basin area rate.

Various producers insist that we erred in our treatment of refunds. We held that refunds must be on a company-by-company and schedule-by-schedule basis. We are now convinced that such holding was wrong and is inconsistent with our conclusion that satisfaction of the end result test requires rates which will equate group revenues with group revenue requirements.

The refunds in question relate to collections made during the so-called "locked-in" periods, i.e., the periods during which an increased rate, later superseded by a further increase, is effective. See Second Phillips, 373 U.S. 294, 298, fn. 5. In that case the Court said that on the locked-in rate issue "the sole question was whether all or any part of the increases had to be refunded by Phillips." The Court pointed out that the Commission decided that the increases

did not bring revenues up to cost of service, and held that the Commission "properly concluded" that "no refund obligations could be imposed." *Id.* at 306.

We are now convinced that this treatment of refund obligations for locked-in rates in the case of an individual company in Second Phillips must be applied on a group basis when an area rate is fixed and tested by the end result. We are also convinced that our reliance on Federal Power Commission v. Tennessee Gas Transmission Co., 371 U.S. 145, was misplaced. That case dealt with zone rates. The Second Phillips decision on locked-in rates came later.

This modification of the opinion means that no refund obligation may be imposed for a period in which there is a group revenue deficiency. When group revenues exceed group revenue requirements, refunds may be ordered on some equitable contract-by-contract basis. In fixing an area rate, the Commission must consider the effect which past and potential refunds have on the balancing of group revenues with group revenue requirements.

In all respects, except those specifically noted herein, the petitions for rehearing are severally denied.

Supplemental Appendix C

Section 7 of the Natural Gas Act

Construction, extension, or abandonment of facilities; certificate of convenience and necessity; condemnation proceedings

SEC. 7. (a) Whenever the Commission, after notice and opportunity for hearing, finds such action necessary or desirable in the public interest, it may by order direct a natural-gas company to extend or improve its transportation facilities, to establish physical connection of its transportation facilities with the facilities of, and sell natural gas to, any person or municipality engaged or legally authorized to engage in the local distribution of natural or artificial gas to the public, and for such purpose to extend its transportation facilities to communities immediately adjacent to such facilities or to territory served by such natural-gas company, if the Commission finds that no undue burden will be placed upon such natural-gas company thereby: *Provided,* That the Commission shall have no authority to compel the enlargement of transportation facilities for such purposes, or to compel such natural-gas company to establish physical connection or sell natural gas when to do so would impair its ability to render adequate service to its customers.

(b) No natural-gas company shall abandon all or any portion of its facilities subject to the jurisdiction of the Commission, or any service rendered by means of such facilities, without the permission and approval of the Commission first had and obtained, after due hearing, and a finding by the Commission that the available supply of natural gas is depleted to the extent that the continuance of service is unwarranted, or that the present or future public convenience or necessity permit such abandonment.

(c) No natural-gas company or person which will be a natural-gas company upon completion of any proposed construction or extension shall engage in the transportation or sale of natural gas, subject to the jurisdiction of the Commission, or undertake the construction or extension of any facilities therefor, or acquire or operate any such facilities or extensions thereof, unless there is in force with respect to such natural-gas company a certificate of public convenience and necessity issued by the Commission authorizing such acts or operations: *Provided, however,* That if any such natural-gas company or predecessor in interest was bona fide engaged in transportation or sale of natural gas, subject to the jurisdiction of the Commission, on February 7, 1942, over the route or routes or within the area for which application is made and has so operated since that time, the Commission shall issue such certificate without requiring further proof that public convenience and necessity will be served by such operation, and without further proceedings, if application for such certificate is made to the Commission within ninety days after February 7, 1942. Pending the determination of any such application, the continuance of such operation shall be lawful.

In all other cases the Commission shall set the matter for hearing and shall give such reasonable notice of the hearing thereon to all interested persons as in its judgment may be necessary under rules and regulations to be prescribed by the Commission; and the application shall be decided in accordance with the procedure provided in subsection (e) of this section and such certificate shall be issued or denied accordingly: *Provided, however,* That the Commission may issue a temporary certificate in cases of emergency, to assure maintenance of adequate service or to serve particular customers, without notice or hearing,

pending the determination of an application for a certificate, and may by regulation exempt from the requirements of this section temporary acts or operations for which the issuance of a certificate will not be required in the public interest.

(d) Application for certificates shall be made in writing to the Commission, be verified under oath, and shall be in such form, contain such information, and notice thereof shall be served upon such interested parties and in such manner as the Commission shall, by regulation, require.

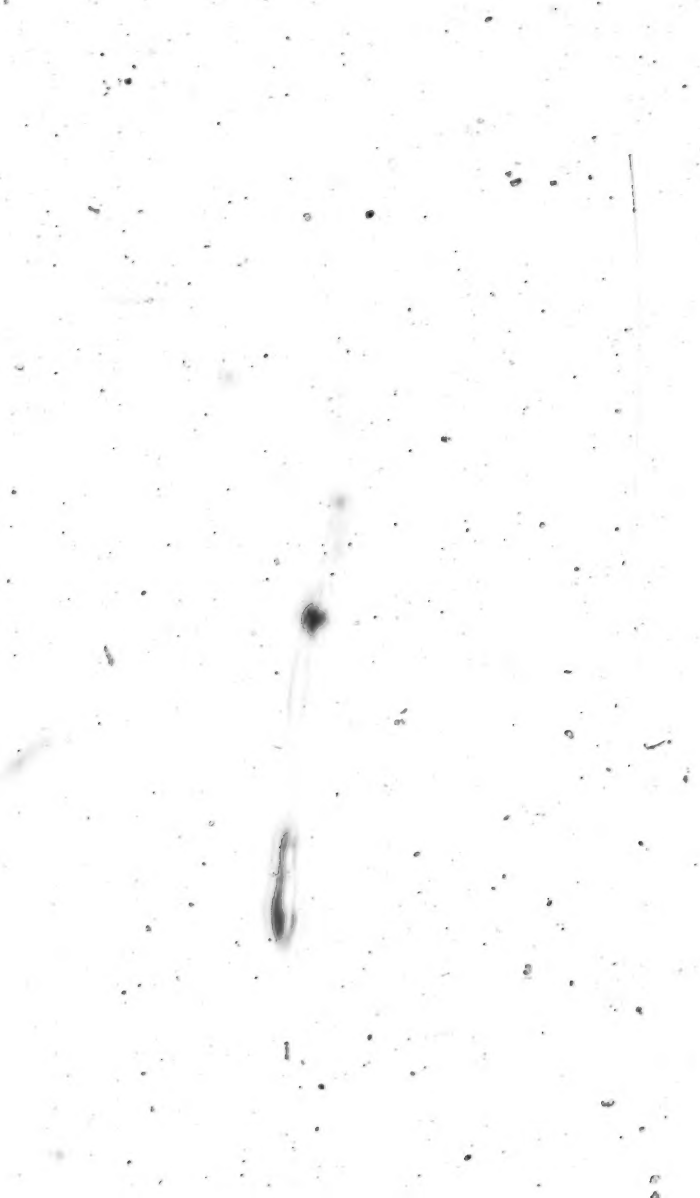
(e) Except in the cases governed by the provisos contained in subsection (c) of this section, a certificate shall be issued to any qualified applicant therefor, authorizing the whole or any part of the operation, sale, service, construction, extension, or acquisition covered by the application, if it is found that the applicant is able and willing properly to do the acts and to perform the service proposed and to conform to the provisions of this chapter and the requirements, rules, and regulations of the Commission thereunder, and that the proposed service, sale, operation, construction, extension, or acquisition, to the extent authorized by the certificate, is or will be required by the present or future public convenience and necessity; otherwise such application shall be denied. The Commission shall have the power to attach to the issuance of the certificate and to the exercise of the rights granted thereunder such reasonable terms and conditions as the public convenience and necessity may require.

(f) The Commission, after a hearing had upon its own motion or upon application, may determine the service area to which each authorization under this section is to be limited. Within such service area as determined by the Commission a natural-gas company may enlarge or extend

its facilities for the purpose of supplying increased market demands in such service area without further authorization.

(g) Nothing contained in this section shall be construed as a limitation upon the power of the Commission to grant certificates of public convenience and necessity for service of an area already being served by another natural-gas company.

(h) When any holder of a certificate of public convenience and necessity cannot acquire by contract, or is unable to agree with the owner of property to the compensation to be paid for, the necessary right-of-way to construct, operate and maintain a pipe line or pipe lines for the transportation of natural gas, and the necessary land or other property, in addition to right-of-way, for the location of compressor stations, pressure apparatus, or other stations or equipment necessary to the proper operation of such pipe line or pipe lines, it may acquire the same by the exercise of the right of eminent domain in the district court of the United States for the district in which such property may be located, or in the State courts. The practice and procedure in any action or proceeding for that purpose in the district court of the United States shall conform as nearly as may be with the practice and procedure in similar action or proceeding in the courts of the State where the property is situated: *Provided,* That the United States district courts shall only have jurisdiction of cases when the amount claimed by the owner of the property to be condemned exceeds $3,000. [52 Stat. 824 (1938); 15 U.S.C. § 717f, as amended.]



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CARD 17

BRIEF IN OPPOSI-
TION TO PETITION
FOR A WRIT OF
CERTIORARI

JOHN F. DAVIS, CLERK

IN THE

Supreme Court of the United States

October Term, 1966

Nos. 1342, 1293, 1295 and 1412

FEDERAL POWER COMMISSION, *et al.*,
Petitioners,

vs.

SKELLY OIL COMPANY, *et al.*,
Respondents.

ON PETITIONS FOR WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

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ON PETITIONS FOR WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR RESPONDENTS IN OPPOSITION

Questions Presented

The Court of Appeals found that an area rate order of the Federal Power Commission did not contain findings which the court deemed essential to enable it to determine whether the order was valid under the end result test. The court, while approving much of the order, remanded it to enable the Commission to make the required determinations and to complete the administrative task so that judicial review could be meaningfully undertaken. The questions thus presented are:

1. Whether the court below erred in remanding for completion of the administrative process an area rate order of the Federal Power Commission in which the Commission conceded that it had not determined, and on the record could not have determined, that the area ceiling rates established by it as just and reasonable for area producers as a group would afford such producer group the opportunity to

recover its revenue requirements as those requirements were found by the Commission.

2. Whether the court erred in concluding that in an area rate proceeding the Commission may not lawfully order refunds unless, during some portion of the "locked-in" period, the revenues of the area producers as a group exceed the revenue requirements of such producer group as those requirements were determined by the Commission.

Argument

The landmark nature of this first area rate case is likely to give the luster of plausibility to any petition for certiorari dealing with it. The general significance of the matter should not, however, overshadow the necessity for completion of the administrative process before plenary consideration is undertaken by this Court. Forbearance at this time will, we believe, result in ultimate expedition.

As to the questions presented by the four petitions to which this opposition relates, the court below, consistent with applicable and well-embedded regulatory principles established by this Court, has merely laid bare the manifest error of the Commission in not completing its administrative task, and thereupon properly remanded the Commission's order to enable the Commission to rectify the deficiency. The court has thus done that which, had it failed to do so, we feel this Court would have felt compelled to do. Consequently, the Court of Appeals has not "decided an important question of federal law which has not been, but should be settled by this court" nor has it "decided a federal question in a way in conflict with applicable decisions of this court."*

1. On the revenue-revenue requirement issue the essence of the court's conclusion was that the commission's order was not ripe for meaningful judicial testing in light

* Rule 19(1)(b), Revised Rules of Supreme Court.

of applicable regulatory principles. By its own admission (Cal. App. 357) * the Commission had not considered or determined and, indeed, from the record could not have determined, whether the area ceiling rates established by it would afford the regulated entity the opportunity to recover its revenue needs as the Commission itself found those needs to be. The Commission was unconcerned with —and from the evidence of record could not have reasonably apprised itself of—the impact which its rates would have on the regulated entity. The court was therefore confronted with a rate order which neither considered nor contained a finding relating to an aspect of rate making which was essential to enable it to ascertain whether the order was just and reasonable in its consequences.

With the case in that posture at the review level, the Court of Appeals, unless it was to override legal doctrine long established by this Court, was left with no choice but to conclude that the Commission must come forth with record-supported finding on one of the most crucial aspects of this case. To give itself something to review in light of the end result test, and with careful observance of the administrative function, the court remanded the order.

Any other action by the court would have constituted an abdication of its judicial responsibility. If the Commission is at liberty to ignore the revenue deficit which will result from its rate order, or if the Commission is free to protect its rate orders from judicial scrutiny by the mere assertion —untested and not supportable on the record—that the rates strike a "fair relationship" between aggregate prices to consumers and aggregate costs to producers, then judicial review is meaningless. The judicial review function would thereupon be that of merely stamping approval to every rate order issued by rate making agencies.

The Court of Appeals actually accorded more than due deference to the administrative order in this case. The Commission *said* that its ceiling rates would bring about a "fair relationship" between aggregate prices to consumers

* "Cal. App." refers to the Appendix filed with its petition in this Court by the State of California in No. 1293.

and aggregate costs to producers (J.A. 548d). But the Commission made no findings on the basis of the record as to how this "fair relationship" came about. Nor would the record have supported any such finding. The court, on the basis of the record, could have properly concluded that the rates designed by the Commission would not produce a fair relationship between aggregate consumer prices and aggregate producer costs.* Nonetheless, with more

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* The record clearly shows that the Commission's ceiling rates will not provide a fair relationship between aggregate prices paid by consumers and aggregate costs incurred by prolucers. The record reflects the following for the year 1960, the "test year" used in this proceeding:

COST-REVENUE RELATIONSHIPS—1960 (*Flowing Gas*)

Industry's unit cost as found by Commission	14.39	cents per Mcf (Cal. App. 126)
Industry's unit revenue at contract prices including increases	12.72	cents per Mcf (J.A. 538e)
Industry's unit revenue deficiency	1.67	cents per Mcf
On a total dollar basis the figures are:		
Producers' test year aggregate costs	$123.9	million (Cal. App. 126; Exh. 175, Sch. 1, J.A. 538e)
Producers' aggregate test year revenues —	$109.5	million (Exh. 118, Sch. 3, J.A. 291e)
Producers' test year total dollar revenue deficiency	$14.4	million

The foregoing revenue deficiency of more than $14 million will be substantially increased by virtue of the quality deductions imposed by the Commission. While there is no record evidence to indicate the extent of these quality deductions, in its 1966 Annual Report to Congress (released after the initial decision of the court below) the Commission states that the quality adjustments will result in reductions of Permian Basin producers' prices of approximately $8 million *per year* (Federal Power Commission 1966 Annual Report, p. 131). That, again, is but a post-decision estimate.

than due deference to the administrative process, and because of the unascertainable impact of the quality deductions, the court merely remanded the Commission's order to enable it to complete the performance of its duty.

The Commission admits that it did not determine whether its *ceiling* rates, which it fixed at the same unit figure as that which it found to be the industry's *average* unit revenue requirement, would enable the industry to recover that revenue requirement (J.A. 1114(d)). In this regard, the court observed (Cal. App. 413):

> "The Commission concedes that it did not equate jurisdictional costs to jurisdictional revenues. This is obvious because no determination was made of the jurisdictional revenues which the rates will produce."

No court, we suggest, can meaningfully review a rate order when the regulatory agency does not, and upon the basis of the record cannot, determine what revenues will be forthcoming from the ceiling rates established by the order. How, in the absence of such determination, can any court realistically evaluate whether such rate order is "unjust and unreasonable in its consequences" (*F.P.C.* v. *Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944)); or evaluate the "impact of the rate order" (*id.*, p. 602)? The court below found itself unable to do so and hence correctly remanded the order to enable the Commission to complete its required task.*

---

* The Examiner concluded that: "Rate design is concerned with insuring that producers as a group have a practical opportunity to realize the revenue standard under their contracts and with the distribution of that total amount among the various contracts" (J.A. 244d). The Commission rejected this conclusion of the Examiner.

It is also noteworthy that in the Southern Louisiana Area Rate Proceeding, AR61-2, pending before the Commission on exceptions to the Examiner's decision, a large number of gas distributors who

The instant petitions, although each may express the issue somewhat differently, are all based principally upon the premise that the Commission was not required to concern itself with the revenues which area producers would receive under its ceiling rates, or whether such revenues would be in substantial balance with revenue needs. The principal basis for the instant petitions for certiorari is that the Commission had no obligation to design rates which would afford area producers the opportunity to recover their revenue requirements which the Commission itself determined to be appropriate for them; and that the court's review function came to a halt merely because the Commission *said* its rates resulted in a fair relationship between consumer prices and producer costs. Thus the petitioners urge this Court to review this case in the light of an obviously deficient administrative order which must be rectified before even the Court of Appeals can properly exercise its review function.

As heretofore stated, the Commission fixed the *ceiling* price for flowing gas at the *average* unit revenue requirement which, in turn, was arrived at essentially on the basis of the *average* historical unit cost of gas-well gas. The

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are participants under the name of Associated Gas Distributors, take the following position in their brief filed with the Commission:

> "Unlike *Permian,* the impact of a commission rate order can be determined on this record, and we contend that it should be considered in fixing rates." Brief of Associated Gas Distributors Opposing Exceptions, AR61-2, page 103, fn. 121.

And:

> "We have urged before . . . that in Southern Louisiana a matching of costs and revenues can and should be made." (*Id.,* page 124.)

Thus, in the second area rate proceeding a large group of distributors are urging that the Commission should do that which the instant petitioners contend the court below erred in requiring the Commission to do here. Those distributors also concede that the record in this (*Permian*) proceeding does not permit determination of the impact of the Commission's rate order.

average unit cost was found to be 14.39 cents per Mcf which was rounded off to 14.5 cents per Mcf as the ceiling price for flowing gas.* Existing prices above the ceiling were reduced to the ceiling, but prices below the ceiling were not increased to it.* Additionally, the Commission limited the ceiling price entitlement to only that gas meeting its criterion of "pipeline quality". It then required substantial but undetermined reductions from such ceiling prices for gas failing to meet its "pipeline quality" standard. Since, as found by the Commission, much of the gas involved is not of "pipeline quality"** and would, therefore, be subject to reductions below the ceiling, the industry's revenue will necessarily fall further substantially below its revenue requirements as determined by the Commission.*** The Commission does not deny the deficiency in

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* The same principle, but with different figures, was applied to "new" gas.

* Petitioners contend that the court below ordered the Commission to increase contract prices. As shown *infra*, page 12, that is not so. We have never contended, either before the Commission or the court below, that contract prices should be *increased*. We have only contended that, absent a valid finding that existing prices are unjust and unreasonable, they cannot lawfully be *reduced*.

** The court below found that "[a]bout 90% of the flowing gas is substandard" (Cal. App. 420).

*** The Commission's lack of concern with balancing industry revenues with revenue requirements in this case should be contrasted with the goal of area ratemaking as presented to this Court in *Wisconsin* v. *F.P.C.*, 373 U.S. 294 (1963), (sometimes referred to as *Second Phillips*), wherein the Court observed (309-310):

> "The Commission has stated in its opinion in this proceeding that the goal is to have rates based on the 'reasonable financial requirements of the industry' in each production area, 24 FPC, at 547, and we were advised at oral argument that composite cost-of-service data will be considered in the area rate proceedings."

revenues. Rather, it asserts the lack of any obligations to concern itself with the deficiency. In fact, the Commission considered that it is under no obligation even to ascertain the amount of such deficiency, and on this record it was impossible to determine the impact of the quality deductions. As the court observed, the controlling question of whether the revenue requirements of the area producers as a group can be satisfied by the rates designed by the Commission "cannot be answered because the financial impact of the quality deductions is not ascertainable from the record" (Cal. App. 425-426).

This Court has held that in enacting the Natural Gas Act, Congress was not only concerned with protection of consumers from excessive prices for natural gas, but Congress

> ". . . was also manifesting its concern for the legitimate interests of natural gas companies in whose financial stability the gas-consuming public has a vital stake. Business reality demands that natural gas companies should not be precluded by law from increasing the prices of their product whenever that is the economically necessary means of keeping the intake and outgo of their revenues in proper balance. . . ." *United Gas Pipe Line Co. v. Memphis Light, Gas & Water Division*, 358 U.S. 103, 113 (1958).

Since the Natural Gas Act enables natural gas companies to *increase* their rates when that is necessary to keep revenue intake and outgo in proper balance, it seems indisputable that the Act did not empower the Commission to reduce existing gas prices without knowledge of or regard for the consequences of such action upon the financial integrity of natural gas companies.

Viewed in the light that the Commission violated a basic regulatory principle and stopped short of completing the administrative task, it is apparent that the issues raised

in these petitions are premature. The court below has upheld the Commission on every issue of method of area rate regulation and on many other major aspects of its ruling.* The court, in substance, has merely held that the Commission had not completed its regulatory task and that its order could not be properly reviewed until that was accomplished. Arguments of the petitioners with respect to "fair relationship" as opposed to "end result" are only variations of arguments that the Commission need not know the ultimate effect of its rate order.

Similarly, arguments that the Commission's ceiling prices do not constitute average costs; that some costs are in fact less than determined by the Commission; and that the Commission properly dealt with the quality problem

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* In a public address by the Chairman of the Commission, he stated:

> "We have been encouraged by the substantial affirmation of the area rate approach by the Court of Appeals for the Tenth Circuit. In its decision, that Court squarely approved the group ratemaking approach and approved as well most of our applications of the concept, including the two-price system and the moratorium. Though the Court thought it necessary to remand the case to the Commission for further work on some points, the Commission intends to appeal for an early hearing in the Supreme Court to avoid the inevitable delay inherent in bringing the case back for further deliberations at this time, and then sending it back up the judicial ladder." (An Address by Lee C. White, Chairman, Federal Power Commission, Before the Texas Independent Producers and Royalty Owners Association, Austin, Texas, April 17, 1967, page 4.)

We do not agree with the Chairman that completion of the administrative function prior to this Court's review will cause delay. This case should not reach the top of the "judicial ladder" until the Commission has completed the required "further work on some points" to put the case in a properly reviewable posture.

in the rate of return,* do not now present matters requiring consideration by this Court. Congress has entrusted the review of such matters to the Courts of Appeals, and it is for those courts to determine in the first instance whether such claims are valid. In this instance the Commission has failed to make the findings which are essential to permit the lower court to perform its assigned review function. *Florida* v. *United States*, 282 U.S. 194, 215 (1931); *S.E.C.* v. *Chenery Corp.*, 318 U.S. 80 (1943); *Colorado-Wyoming Gas Co.* v. *F.P.C.*, 324 U.S. 626, 634 (1945); *Burlington Truck Lines* v. *United States*, 371 U.S. 156, 167-168 (1962).

The court below has performed its review function in the only way it could on the record presented, by directing the Commission to complete its regulatory assignment in order that the court could in turn fulfill its function. In answer to the various defenses raised by the Commission, the court concluded (Cal. App. 429-430):

> "We have accepted the Commission's conclusion that contract rates should not be used. The trouble is that the Commission decision rides two horses and we have no way of knowing the outcome of the race. It uses composite cost-of-service evidence, engrafts economic factors on top, and comes out with a rate which it justifies on a fair relationship basis. We have the problem of how in such circumstances a court can determine whether the just and reasonable standard of §§ 4 and 5 has been met. The answer is not found in the record before us.

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* The first question presented in the Government's petition implies that the court below found the rate of return fixed by the Commission to be inadequate. The court made no such determination. The court did question the propriety of including an ascertainable cost, *i.e.*, what it would cost to bring Permian gas up to pipeline quality, as a risk, and attempting as the Commission did to compensate therefor by some unascertainable portion of the rate of return. The court said (Cal. App. 422):

> "The fact is that by treating quality deductions as a risk rather than a cost the Commission has made it impossible to determine the amount of return with any degree of certainty."

> "The facts sustaining the conclusion of fair relationship must be found. The Commission did not make those findings and indeed it could not have done so because of the failure of the record to disclose the revenue impact of the adjustments in area rates to reflect quality differentials."

The Government's first question presented inquiries whether the Commission erred in treating quality deductions as a risk rather than a cost.* No matter the answer to that question, the case has to go back to the Commission to complete its task and to put the Commission's order in a reviewable posture, because, as the Court of Appeals found (Cal. App. 430):

> "... Whether rate reductions because of quality deficiencies are a risk or a cost, the answer comes out the same. If they are a risk, we do not know the rate of return. If they are a cost, we do not know whether the revenue received will equal the reasonable revenue requirements. We believe that under Hope, and under Second Phillips, the area producers, as a group, are entitled to recover their prudent operating expenses and capital costs with a return commensurate to the risk and sufficient to attract capital. Satisfaction of this requirement must appear through appropriate findings based on substantial evidence. These cannot be made on the record presented."

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* The Commission determined the cost of finding and producing a *random* unit of gas at the wellhead, without regard to the quality, pressure or Btu content of the gas. Without including in the industry's cost anything for bringing random gas up to its rigid quality and pressure specifications, the Commission, after fixing ceiling rates at the *average* cost of *random* gas and without determining the cost of bringing substandard gas up to pipeline quality, imposed reductions from the ceiling for substandard gas. The Court of Appeals was therefore understandably concerned with such treatment of the quality problem question by the Commission. But for present purposes, as hereafter indicated above, this question need not now be faced by this Court. Whether the quality deduction be treated as a risk or a cost, neither the Commission nor the Court of Appeals could ascertain on this record the impact thereof.

The arguments in the petitions that the court required the Commission to raise existing contract rates simply misconstrue what the court did. The court fully recognizes the doctrine established by this Court in *Mobile* * and *Sierra.*** The court's conclusion was that it could not determine—nor did the Commission itself determine—whether the minimum and maximum rates established by the Commission would afford the regulated entity the opportunity to recover its revenue requirements as determined for it by the Commission. The court puts this issue in proper focus by saying (Cal. App. 425-426):

> "We believe that the controlling question is whether the proper revenue requirements of the area producers as a group can be satisfied with rates having the ceiling and the floor which the Commission has fixed. This cannot be answered because the financial impact of the quality deductions is not ascertainable from the record."

2. On rehearing the court concluded that refunds on some equitable contract-by-contract basis could be ordered only after the Commission determined that the regulated entity's revenues exceeded its revenue requirements for some portion of the locked-in period (Govt. Pet. 46).*** No other conclusion will afford the regulated entity the opportunity of keeping its revenues in substantial balance with its revenue needs. The court's conclusion is also required by this Court's holding in *Second Phillips* (*Wisconsin* v. *F.P.C.*, 373 U.S. 294, *supra*), in which the Court held (373 U.S. at 306):

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* *United Gas Pipe Line Co.* v. *Mobile Gas Service Corp.*, 350 U.S. 332 (1956).

** *Federal Power Commission* v. *Sierra Pacific Power Co.*, 350 U.S. 348 (1956).

*** The Examiner had also concluded that refunds could be ordered only to the extent that aggregate industry revenues exceeded aggregate industry costs (J.A. 267d).

> "Since these increased rates were 'locked in', their validity for the future was not at issue; the sole question was whether all or any part of the increases had to be refunded by Phillips. Having decided on the basis of substantial evidence that the increases did not bring revenues up to cost of service, the Commission properly concluded, on the only matter before it with respect to these dockets, *that no refund obligation could be imposed.*" (Emphasis added.)

3. The questions presented in some of the instant petitions relating to the court's action on the issue of special exemptions, appear to be based upon a misconception of the court's conclusion. The court did not require the Commission to include in its order a savings clause which would automatically entitle each producer to a stay of the general order until its claim for exemption was decided. All the court did was remand the case with instructions that the savings clause should contain *guidelines* which, *if followed,* would entitle an aggrieved producer to a prompt hearing and a stay of the general order. The court ruled (Cal. App. 419):

> "An adequate savings clause should contain *guidelines which if followed* by an aggrieved producer will permit it to be heard promptly and to have a stay of the general rate order until its claim for exemption is decided." (Emphasis added.)

Thus, the Commission has full authority to promulgate the guidelines which, if followed, will enable an aggrieved party to a meaningful hearing.

Conclusion

The judgment of the court below, remanding the Commission's order for completion of the administrative process, is clearly correct. It would be premature for this

Court to give plenary consideration to this case at this stage of incomplete administrative action. The petitions for writs of certiorari should be denied.

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May 1967

RESPONDENT'S BRIEF

~~Nos. 1200, 1230, 1012 and 1112~~
(and other petitions in the Permian Basin Area Rate Case)

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JOHN F. DAVIS, CL

IN THE

Supreme Court of the United States

OCTOBER TERM, 1966

No. ~~1200~~ 100

PEOPLE OF THE STATE OF CALIFORNIA, *et al.*, *Petitioners*,

v.

SKELLY OIL COMPANY, *et al.*

No. ~~1205~~ 102

PACIFIC GAS AND ELECTRIC COMPANY, *et al.*, *Petitioners*,

v.

SKELLY OIL COMPANY, *et al.*

No. ~~1012~~ 117

FEDERAL POWER COMMISSION, *Petitioner*,

v.

SKELLY OIL COMPANY, *et al.*

No. ~~1112~~ 181

THE CITY OF LOS ANGELES, *Petitioner*,

v.

SKELLY OIL COMPANY, *et al.*

On Petitions for Writs of Certiorari to the United States Court of Appeals for the Tenth Circuit

BRIEF OF RESPONDENT STANDARD OIL COMPANY OF TEXAS IN OPPOSITION

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May 31, 1967

PRESS OF BYRON S. ADAMS PRINTING, INC., WASHINGTON, D. C.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1966

Nos. 1293, 1295, 1342 and 1412
(and other petitions in the Permian Basin Area Rate Case)

No. 1293

PEOPLE OF THE STATE OF CALIFORNIA, *et al.*, *Petitioners*,

v.

SKELLY OIL COMPANY, *et al.*

No. 1295

PACIFIC GAS AND ELECTRIC COMPANY, *et al.*, *Petitioners*,

v.

SKELLY OIL COMPANY, *et al.*

No. 1342

FEDERAL POWER COMMISSION, *Petitioner*,

v.

SKELLY OIL COMPANY, *et al.*

No. 1412

THE CITY OF LOS ANGELES, *Petitioner*,

v.

SKELLY OIL COMPANY, *et al.*

On Petitions for Writs of Certiorari to the United States Court of Appeals for the Tenth Circuit

BRIEF OF RESPONDENT STANDARD OIL COMPANY OF TEXAS IN OPPOSITION

PRELIMINARY STATEMENT

In these cases, the Federal Power Commission, the State of California, several California distributing companies and the City of Los Angeles seek review of a decision of the Court of Appeals. Respondent is a

producer of natural gas in the Permian Basin Area and was a party below. The States of New Mexico and Texas,[1] and certain producers who were parties below,[2] have also filed petitions. The petition of producer Perry R. Bass, *et al.* (No. 1302) is conditional. It submits that all petitions should be denied and prays for a writ only in the event the other petitions should be granted.[3] For reasons hereinafter stated respondent herein submits that review by this Court at this time would be premature and that all petitions should be denied.

QUESTION PRESENTED

Numerous subsidiary issues are presented in the petitions of the various parties already on file. Many of these issues are important if ultimately they remain in the case. But review is now being sought at an interlocutory stage. Accordingly, the sole question before this Court in determining whether writs of certiorari should now issue is whether this Court should consider and pass upon the many questions raised in the various petitions (a) before the administrative record, findings and decision provide a sufficient basis for a court finally to review the validity of the Commission's rate orders under the standards of the Natural Gas Act, and (b)—as to the petitioning producers—before the Commission has issued final rate orders which may not adversely affect them.

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[1] No. 1291.

[2] Nos. 1274, 1287, 1292, 1294, 1302.

[3] Respondent herein also reserves the right to file a conditional petition for a writ of certiorari in the event other writs should be granted. The time for filing such a petition does not expire until July 17, 1967.

STATEMENT

In its opinion, issued August 5, 1965, in the Permian Basin Area Rate Case, the Commission prescribed maximum and minimum rates for independent producers selling natural gas for resale in interstate commerce from fields in the Permian Basin area of west Texas and southeastern New Mexico.[4] The decision promulgated rate orders on a group or area basis but also provide a special procedure for individual producers to seek exemption from the rates. Essentially, all of the rates were based on average unit costs of producers as a group, including a return on investment fixed by the Commission. The Commission's basic procedure, in computing a cost of gas flowing during the test year, was to allocate various joint costs between gas and liquids, and divide the total gas costs by the total gas volumes to derive unit costs per Mcf. The Commission computed a total of these unit costs,[5] rounded them off,[6] and then, since the costs included a return on investment, prescribed these figures as *ceiling rates.*[7] At the same time, however, the Commission promulgated quality standards and provided that ceiling rates should be adjusted downward by the net cost to the

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[4] Opinion No. 468, 34 FPC 159, modified on rehearing, Opinion No. 468A, 34 FPC 1068.

[5] 16.43¢ for Texas production of new gas-well gas; 14.39¢ for Texas production of flowing gas. The New Mexico figure was 1¢ less in each case because it was exclusive of state production taxes.

[6] 16.5¢ for Texas production of new gas-well gas; 14.5¢ for Texas production of flowing gas; New Mexico 1¢ less in each instance.

[7] For the computation see the opinion of the court below, Continental Petition, No. 1274, pp. 30a-31a.

pipelines of processing the gas to bring it up to the standards prescribed by the Commission.

A very large percentage of the gas produced in the Permian Basin is sub-quality and requires additional processing to meet the Commission's quality standards.[8] Nevertheless, the Commission made no record or finding as to the cost of pipeline processing. Accordingly, nothing in the administrative record shows what revenues the prescribed rates will yield to the producers. The Commission sought to justify its failure in this regard by saying that the rates were only "geared" to costs, that it considered factors other than costs (although the record does not disclose what the other factors are),[9] that it had allowed a generous rate of return, and that it was satisfied "that the ceiling prices we have fixed 'provide a fair relationship between the aggregate price the consumer pays and the aggregate costs that the producers incur' in the Permian Basin."[10]

The gap in the Commission's findings concededly relates to a substantial issue. As the court below said:

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[8] The Commission's standards limited the content of carbon dioxide, hydrogen sulphide, total sulphur, water and other impurities, and established minimum delivery pressures and BTU contents. Much of the gas-well gas produced in the Permian Basin Area contains unusually high quantities of carbon dioxide and sulphur. Additionally much of the gas produced in the area is produced in association with oil and is delivered at relatively low pressures.

[9] See the opinion of the court below, Continental Petition, No. 1274, pp. 31a-32a, 50a.

[10] Opinion below, Continental Petition, No. 1274, p. 33a.

"About 90% of the flowing gas is substandard. We are cited to no figures on the similar percentage of new gas-well gas. The amount of the rate adjustments does not appear in the record because there was no evidence of the extent of quality differentials or of the processing costs of bringing the gas up to standard. At oral argument various estimates were given as to the amount of rate reduction which would result from substandard quality. These were based on statements filed pursuant to the decision but after the record was closed. They ranged from .7 cents to 2.0 cents per Mcf. A spokesman for the Continental Group said that on 1960 volumes a revenue deficiency of some $12 million a year would result. The Commission response in this court to the Skelly motion for stay of the Commission's orders herein said that the reductions in applicable rates because of adjustments for quality standards are expected to result in a revenue reduction of about $10 million annually." (Continental Petition, No. 1274, pp. 41a-42a)

The Tenth Circuit affirmed the Commission's use of the area rate method and accepted most of its underlying determinations. However, it held that the record before the Commission, and the Commission's findings, were deficient, *inter alia,* in that they failed to consider or determine the cost of processing substandard gas. Accordingly, it remanded the case for additional evidence and findings on this question. The court said:

"The Commission says that the impact of the quality adjustments is taken care of in the rate of return which is made generous on this account.

* * *

"A fair rate of return cannot be ascertained with mathematical certainty. Pragmatic adjustments may be made by an agency within the ambit

of its statutory authority. A court must put great reliance on agency expertise in evaluating a rate of return but this does not mean that a court must accept the agency determination in blind faith" (Continental Petition, No. 1274, pp. 42a-44a)

* * *

And again:

"* * * The Commission did not make those findings and indeed it could not have done so because of the failure of the record to disclose the revenue impact of the adjustments in area rates to reflect quality differentials. Whether rate reductions because of quality deficiencies are a risk or a cost, the answer comes out the same. If they are a risk, we do not know the rate of return. If they are a cost, we do not know whether revenue received will equal the reasonable revenue requirements. We believe that under Hope, and under Second Phillips, the area producers, as a group, are entitled to recover their prudent operating expenses and capital costs with a return commensurate to the risk and sufficient to attract capital. Satisfaction of this requirement must appear through appropriate findings based on substantial evidence. These cannot be made on the record presented." (Continental Petition, No. 1274, pp. 50a-51a)

And again:

"Nothing in Second Phillips rejects the end result test of Hope. We believe that it applies here and that it is not satisfied by a finding of fair relationship. Something more than mere semantics is involved. * * *

"* * * the producer * * * is entitled to recover its prudent operating expenses and capital costs with a return commensurate to the risk and sufficient to attract capital. These requirements must

be tested against the record. They may not be brushed aside with a general finding of fair relationship. The Commission concedes that it did not equate * * * costs to * * * revenues. This is obvious because no determination was made of the * * * revenues which the rates will produce." (Continental Petition, No. 1274, pp. 34a-35a)

REASONS FOR DENYING THE PETITIONS

The action of the Court of Appeals in remanding the case for the taking of further evidence and the making of additional findings on the quality issue is, we submit, clearly correct. Further, under any of the contentions of any of the parties, such evidence and findings clearly are relevant. The appropriate exercise of the certiorari jurisdiction of this Court requires that the record be completed before this Court undertakes the review of such questions as may remain in the case after the final determination by the court below. As pointed out above, the amounts involved in the quality determinations are substantial. Further findings may result in rates satisfactory to many of the producers and thus moot issues which are now raised.

The Commission urges "the obvious desirability of winding up this first area proceeding at the earliest possible date" (Petition, No. 1342, p. 18). But only delay can result from an interlocutory review if this Court should agree—as we submit it will—with the conclusion of the court below that findings on the quality issue are necessary to permit appropriate judicial review of the validity of the rate order. Most of the issues in the case have been determined favorably to the Commission by the court below. The issue on remand is a limited one. Any excess rates which may

be collected are subject to appropriate refund. The Commission can best hasten the ultimate determination of all of the issues by expediting its proceedings on remand and providing a record which will permit final review by this Court.

CONCLUSION

All of the petitions for writs of certiorari in these proceedings should be denied.

Respectfully submitted,

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May 31, 1967

JOINT

BRIEF IN OPPOSI-TION TO PETITION FOR A WRIT OF CERTIORARI

Nos. 1274, 1293, 1295, 1342, et al.
(Petitions in "The Permian Basin Area Rate Case")

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JOHN F. DAVIS, C

IN THE

Supreme Court of the United States

OCTOBER TERM, 1966

No. 1293

PEOPLE OF THE STATE OF CALIFORNIA, *et al.*, *Petitioners*

v.

SKELLY OIL COMPANY, *et al.*

No. 1295

PACIFIC GAS AND ELECTRIC COMPANY, *et al.*, *Petitioners*

v.

SKELLY OIL COMPANY, *et al.*

No. 1342

FEDERAL POWER COMMISSION, *Petitioner*

v.

SKELLY OIL COMPANY, *et al.*

On Petitions for a Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1966

No. 1293

PEOPLE OF THE STATE OF CALIFORNIA, *et al.*, *Petitioners*

v.

SKELLY OIL COMPANY, *et al.*

No. 1295

PACIFIC GAS AND ELECTRIC COMPANY, *et al.*, *Petitioners*

v.

SKELLY OIL COMPANY, *et al.*

No. 1342

FEDERAL POWER COMMISSION, *Petitioner*

v.

SKELLY OIL COMPANY, *et al.*

(and other petitions in the Permian Basin Area Rate Case)

On Petitions for a Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

JOINT BRIEF IN OPPOSITION OF INDICATED RESPONDENTS*

* Respondents include 64 producers of natural gas who were petitioners below. This Brief is submitted only on behalf of Respondents whose names are listed *infra*. These Respondents request that this Brief be deemed responsive to *all* pending petitions seeking a writ of certiorari to the United States Court of Appeals for the Tenth Circuit in the Permian Basin Area Rate Case (Nos. 1274, 1287, 1291, 1292, 1293, 1294, 1295, 1302, 1342, and 1412).

PRELIMINARY STATEMENT

In these and related cases, the Federal Power Commission, the States of New Mexico, Texas, and California, other governmental bodies, and certain gas distribution and producing companies seek review of the decision of the Court of Appeals. However, the petitions essentially fall into two distinct categories: three producer petitions challenge the constitutional and statutory basis of area or group rate making *per se*,[1] while the petitions on behalf of the Commission and its supporters challenge the limited remand by the court below and seek total affirmance of the Commission decision (Nos. 1293, 1295, 1342, and 1412). For reasons stated herein, these Respondents submit that review by this Court at this time would be premature, that the petitions seek review at an interlocutory stage, and that all petitions seeking review of the Permian Basin Area Rate Case thus should be denied.

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[1] These three are Nos. 1287, 1292, and 1294, filed by The Superior Oil Company, Sun Oil Company, and Hunt Oil Company, *et al.* (Superior, Sun, Hunt).

The petition filed by Continental Oil Company and Midhurst Oil Company in No. 1274 essentially challenges the agency's exercise of discretion in its choice of the regulatory method for determining area rates. *Cf. Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944).

The petition filed by Perry R. Bass, *et al.* in No. 1302 is a conditional petition. Petitioners there state that "all petitions for writs of certiorari in this case should be denied and . . . further proceedings should be held by the Federal Power Commission consistent with the opinion of the court below." (Bass Petition, p. 6)

Respondents filing this Brief reserve the right to file similar conditional petitions as to questions decided adversely to them below on January 20, 1967 and on rehearing on April 18, 1967. The time for the filing of such petitions by these Respondents will not expire until July 19, 1967.

OPINIONS BELOW

The opinion of the Court of Appeals remanding the case for further findings is not yet reported. It is set forth in Appendix A to the petition of Continental Oil Company, *et al.* (No. 1274). The opinion of the court granting rehearing in part and requiring further findings is set forth in Appendix B to the petition filed by the Federal Power Commission (No. 1342). The opinions and orders of the Commission are reported at 34 F.P.C. 159 (J.A. 516d-826d), 34 F.P.C. 418 (J.A. 827d-838d), 34 F.P.C. 424 (J.A. 37s), 34 F.P.C. 1068 (J.A. 1105d-1132d), and 34 F.P.C. 1082 (J.A. 1133d-1136d). The opinion of the hearing examiner is reported at 34 F.P.C. 306 (J.A. 97d-364d).

JURISDICTION

The jurisdictional requisites are adequately set forth in the petitions.

STATUTES INVOLVED

The statutory provisions involved are Sections 4, 5, 7, and 19(b) of the Natural Gas Act, 52 Stat. 822, 823, 824, 831 (1938), 56 Stat. 84 (1942), 15 U.S.C. §§ 717c, 717d, 717f, 717o, and 717r, and Sections 8 and 10 of the Administrative Procedure Act of 1946, 60 Stat. 242, 243, as recodified by 80 Stat. 378 (1966), 5 U.S.C. §§ 557 and 704. Sections 4, 5, and 7 of the Natural Gas Act are reproduced in the petition of Continental Oil Company, *et al.* (No. 1274, pp. 3-11); Section 19(b) of the Natural Gas Act is reproduced in Appendix A to this Brief; and Sections 8 and 10 of the Administrative Procedure Act are reproduced in Appendix B to this Brief.

QUESTIONS PRESENTED

1. Numerous subsidiary issues are set forth in the petitions filed by the Commission and its supporters, but there is but a single question before this Court determining whether writs of certiorari should issue as sought by these premature petitions. The Commission decision cannot be affirmed without reversing the holding of the court below that the agency's findings are not sufficiently complete to permit judicial review under *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944), and the question presented thus is:

> Whether the administrative record, findings and decision provide a sufficient basis at this time for a court to review the validity of the agency's rate orders under the standards of the Natural Gas Act.

2. Similarly, there is essentially but a single issue now raised by the producer petitions challenging the Commission's area or group rate method *per se*:

> Whether these petitioners have exhausted administrative remedies, or, stated differently, whether these petitioners may obtain an advisory opinion as to validity of area or group rates as applied to them before their individual rates are determined under the agency's procedures.

STATEMENT

On August 5, 1965, the Commission issued an area rate decision which, *inter alia*, prescribed maximum and minimum rates for independent producers selling natural gas for resale in interstate commerce from fields in the Permian Basin area of west Texas and

southeastern New Mexico (Opinion No. 468, 34 FPC 1068, modified on rehearing, Opinion No. 468A, 34 FPC 1082).

This decision prescribed rates on a group or area basis but also included a limited procedure for producers to apply for specific exception from the area rates. All of the maximum rates prescribed rested upon Commission computations of average unit costs of producers. However, the Commission also required that the ceiling rates based on these group unit cost determinations be adjusted downward by costs incurred by pipelines to bring gas up to "quality" standards set forth in the Commission decision. Although the Commission made estimates of producers' unit costs, and the bulk of record relates to these estimates, there was no record or finding as to pipelines' costs to be used for the required rate deductions, nor was there any basis in the Commission decision to determine the group revenues actually generated by the prescribed rates.

Pursuant to Section 19(b) of the Act, numerous producers sought review of Opinion Nos. 468 and 468A. Upon review, the Tenth Circuit sustained the Commission in most substantial respects, including the Commission's use of the area rate method for establishing just and reasonable rates for producers. However, the court below remanded for the purpose of permitting additional findings required under Sections 4 and 5 of the Natural Gas Act. Essentially, the court below found the Commission's decision deficient in basic, but limited respects:

(1) Although the agency recognizes that its rate orders are subject to the *Hope* "end result" test, it did not and could not make findings re-

quired by that test on the administrative record in this particular case; and

(2) Neither the administrative record nor the decision provided the reviewing court with a basis to measure the impact of the rate orders.

These gaps in the record and decision, and the required corrective steps, were pinpointed by the court below:

> "Nothing in Second Phillips rejects the end result test of Hope. We believe that it applies here and that it is not satisfied by a finding of fair relationship. Something more than mere semantics is involved. * * *
>
> "* * * the producer * * * is entitled to recover its prudent operating expenses and capital costs with a return commensurate to the risk and sufficient to attract capital. These requirements must be tested against the record. They may not be brushed aside with a general finding of fair relationship. The Commission concedes that it did not equate * * * costs to * * * revenues. This is obvious because no determination was made of the jurisdictional revenues which the rates will produce." (Continental Petition, pp. 34a-35a)
>
> * * *
>
> ". . . In any event, the lack of evidence as to quality deductions makes it impossible to determine whether the rate of return satisfies the Bluefield and Hope principles and we have no basis on which to appraise the allowance made by the Commission. We respect the expertise of the Commission but the conclusions reached by the use of expertise must accord with legal standards." (Continental Petition, p. 44a)
>
> * * *
>
> ". . . The Commission held that its ceiling prices provided a fair relationship between consumer prices and producer costs. Fair relationship is

pertinent but it is only part of the end result test. We do not know the producers' costs or revenue requirements. We do not know the economic factors which either require or permit departure from costs and revenues. The end result test is not satisfied by a reliance on unknowns.

"We have accepted the Commission's conclusion that contract rates should not be used. The trouble is that the Commission decision rides two horses and we have no way of knowing the outcome of the race. It uses composite cost-of-service evidence, engrafts economic factors on top, and comes out with a rate which it justifies on a fair relationship basis. We have the problem of how in such circumstances a court can determine whether the just and reasonable standard of §§ 4 and 5 has been met. The answer is not found in the record before us." (Continental Petition, p. 50a)

* * *

"... The Commission will hold such additional hearings as are needed to determine the effect of the quality adjustments, and to determine the group revenues and the group revenue requirements. It will make appropriate findings on these matters ..." (Continental Petition, p. 51a)

This limited remand neither condemns the area rate method adopted by the Commission, nor disturbs most of the underlying determinations made by the agency. In effect, the Court of Appeals merely required the Commission to design rates consistent with its other findings,[2] to supplement the administrative record, and

[2] Indeed, the Commission had reversed the hearing examiner on the requirement for rate design findings. The examiner made rate design findings consistent with group rate decisions of other federal agencies. See, *e.g.*, *Re General Passenger-Fare Investigation*, 32 CAB 291 (1960). Significantly, the Tenth Circuit's holding as to required findings is consistent with views expressed by the examiner.

to receive evidence supporting its decision on quality deductions.[3] Hence, the basic holding of the court below is that the Commission has not completed its functions, and the cases have been remanded for that limited purpose.

ARGUMENT

1. Since the Ultimate Question Is Not Ripe for Review, the Petitions Are Premature and Should Be Denied

In rate cases under the Natural Gas Act, the ultimate substantive question is whether the agency has prescribed just and reasonable rates. All other issues are subsidiary to this question. In this case, the ultimate substantive question cannot be answered at this time. This is the holding of the court below and the reason it directed the Commission, upon remand, to complete its rate design findings. Without this step and completion of the agency's functions, a reviewing court cannot determine exactly what rates have been prescribed in fact, and whether those rates are supported by findings based on substantial evidence and preserve, in fact, the rights of all parties to just and reasonable rates.[4]

---

[3] The Commission continues to concede "the precise extent of these deductions was unknown at the time of the decision" (FPC Petition, p. 12), but this is at best an oversimplification. In fact, there is no basis in the administrative record, and none is cited, for the agency's initial "estimates" of these deductions or for any subsequently reported figures, including those set forth in petitions and briefs filed in this Court.

[4] None of the questions presented or reserved in the numerous petitions here directly challenge this basic holding of the court below. The agency petition in particular seeks to obscure the basic holding below and the fact that the holding rests upon this Court's decisions construing Sections 4 and 5 of the Natural Gas Act, particularly *Federal Power Commission* v. *Hope Natural Gas Co., supra.*

The Court of Appeals thus makes clear that neither the record nor the Commission decision reveals the rates prescribed or the effect of those rates upon the revenues and earnings of the producer-respondents. The court noted that the agency, in its brief to the court, conceded that "appropriate price differentials or adjustments could not be made on the basis of the record." (Continental Petition, p. 41a). Furthermore, the court below concluded that the Commission decision does not set forth the rationale by which the Commission may have moved from the evidence before it to its stated conclusions. Because of *prima facie* gaps in the record and in findings of the agency, the court of appeals also deemed it premature to review subsidary substantive issues relating to the Commission's cost determinations. Remand of the case thus was ordered to permit limited further findings and required explanation of the Commission's rationale.

Despite this, the petitions in these cases now assume that this Court should become the forum for arguments on rate design issues in advance of complete agency findings and decision and review under Section 19(b) of the Natural Gas Act. The numerous issues listed in the petitions thus are, in essence, rate design issues normally passed upon by a rate regulatory agency prior to court review. However, the obvious gaps in the agency's findings in this case prevented review of these questions below. The court below also could not review the methodology employed and data relied upon by the agency, which the court described as buried in

a "turmoil of numbers" and "snarl of statistics."[5] The court also stated that "perhaps in the future courts will have to explore the mysteries of allocation . . .," but refused to be drawn into such review at the present time because of the patent inadequacy of the record and findings before it (Continental Petition, p. 39a). Now, however, if this Court granted the premature petitions in these cases, this Court would be forced into review of these questions and into *de novo* consideration of the rate design issues which the Commission should pass upon in the first instance.

Such interlocutory and *de novo* review will not hasten final disposition of this particular case by an area rate order consistent with the Act's standards.[6] However,

---

[5] Numerous motions under Section 19(b) under Natural Gas Act for leave to file additional evidence before the agency were filed with the Court of Appeals. These motions were denied, not on their merits, but on the basis that on remand, opportunity would exist for the agency to determine necessity for receipt of such additional evidence. Thus, if this Court grants the pending petitions, it necessarily will have to rule on these unresolved matters which have been deferred by the Court of Appeals, pending completion of the administrative record.

[6] The remand by the Tenth Circuit does not entail any inordinate delay in issuance of a perfected final order, as alleged in petitions filed in this Court. Certain of these Respondents have already filed with the Commission petitions for convening of a conference to expedite the proceedings on remand. The Commission thus can consider immediately any required supplementing of the administrative record and could proceed promptly with the additional findings required under the Tenth Circuit's remand directive. The perfected final order thus can cure the defects found by the Tenth Circuit, and, in all likelihood, such an order could eliminate many of the issues raised here by producer-petitioners. Beyond this, the Tenth Circuit's remand of the Permian Basin Area Rate Case does not preclude the agency's proceeding to prompt hearings and decision in four other pending area rate cases (Docket Nos. AR61-2, AR64-1, AR64-2, and AR67-1). Three of the latter cases await

if this Court permits the case to be remanded to the agency, the Commission will be afforded the opportunity to fill in the gaps, proceed with limited, but required additional findings, and prescribe rates consistent with the end result test. Review by this Court at this time thus could result in an interlocutory review of what are now but abstract legal issues, and an advisory opinion without an adequate record before the Court for determination of the actual effect of decision upon the abstract issues listed in the petitions. This Court should not undertake what would be tantamount to such advisory review.[7]

2. The Decision Below Is Consistent With Decisions of This Court

The Court of Appeals has not decided an important question of federal law in a manner conflicting with decisions of this Court.

The court below followed *Burlington Truck Lines, Inc.* v. *United States,* 371 U.S. 156 (1962), requiring that agency findings of fact must cover all essential issues and be stated with clarity sufficient to permit judicial review of the agency's conclusions. The court below also held that the agency's general "fair relationship" expressions did not permit a court to determine that the rates prescribed by the agency are supported by substantial evidence and satisfy the tests

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Commission and examiners' decisions, and the position of most parties is that evidence received or tendered in these cases provides an adequate basis for agency findings held necessary by the Tenth Circuit and the applicable decisions of this Court cited by the Tenth Circuit.

[7] See *Chicago & S. Air Lines* v. *Waterman S.S. Corp.,* 333 U.S. 103, 113 (1948).

of *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944).

Despite this, the Commission and its supporters contend here that the decision below is contrary to *United Gas Pipe Line Co.* v. *Mobile Gas Service Corp.*, 350 U.S. 332 (1956). They assert that, contrary to *Mobile*, the decision below would require the agency to fix all rates above certain contract price levels.[8] This is simply not the fact.[9] The Commission and its supporters suggest that the Court of Appeals directed the agency to adopt a specific rate design in prescribing rates that permit realization of the revenues found to be required. Apparently, this contention rests solely upon the court's approval of the Commission's prescription of minimum as well as maximum rates. However, the court's approval of the agency's concept of minimum rates cannot be so distorted into a judicial requirement that the Commission must raise all low contract prices to a maximum rate level. See *Mississippi River Fuel Corp.* v. *Federal Power Commission*, 252 F. 2d 619, 626 (D.C. Cir.), *cert. den.*, 355 U.S. 904 (1957).

The Commission and its supporters also argue that the court's opinion and order on rehearing are "at odds" with *Federal Power Commission* v. *Tennessee*

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[8] Such Petitioners carefully avoid the later decision in *United Gas Pipe Line Co.* v. *Memphis Light, Gas & Water Division*, 358 U.S. 103, 113 (1958), that natural gas companies shoud be permitted "the economically necessary means of keeping the intake and outgo of their revenues in proper balance."

[9] See, for example, the Examiner's decision at 34 F.P.C. 365-371, JA 244d-253d. Furthermore, such arguments are contrary to the Commission decision fixing minimum rates, 34 F.P.C. 231-232, JA 669d-671d, and *would require this Court to reverse the agency's* use of minimum rates in Opinion 468 and accompanying order.

Gas Transmission Co., 371 U.S. 145 (1962). Such allegations are without merit. This Court's decision in *Tennessee* affirmatively recognized that the Natural Gas Act permits allowance of a rate structure consisting of rates above and below an average cost level but contemplating that the total revenues produced permit recovery of the revenue requirement.[10] See also *Wisconsin* v. *Federal Power Commission*, 373 U.S. 294 (1963). Thus, the Commission and its supporters confuse the question of the overall level of area rates with the question of reasonableness of individual rates. However, the Court of Appeals' decision on issues involving permissible rate structures, as well as its decision on mechanics of computing refunds, is clearly consistent with *Wisconsin* and *Tennessee*.[11]

As shown, petitions filed by the Commission and its supporters thus ignore the principal holding below and seek to substitute premature and subsidiary issues.[12]

---

[10] The Examiner in this case thus held (34 F.P.C. at 372):

> "The reasonableness of area rates concerns the rate level—the average, the maximum and the minimum. Within this framework, the relationship of one rate to another (undue discrimination or preference) is irrelevant to the question of the justness and reasonableness of the over-all structure."

[11] Arguments that the Tenth Circuit's order on rehearing conflicts with this Court's decisions are also premature. The assumption in such arguments—that the court below has held that the Commission *must* permit the collection and retention of unjust and unreasonable rates—is unfounded.

[12] For example, among the premature and subsidiary issues which the agency seeks to magnify into questions calling for this Court's review are (a) whether "quality" deductions are "costs" or "risks," and (b) whether the agency's "savings clause" is adequate. As to the first, the court below did not impose upon the Commission a rigid formula for gas "quality" adjustments. The court merely held that, in the absence of complete findings respect-

All of the arguments of the Commission and its supporters that the court's opinion below necessarily deprives either producers or consumers of rights to just and reasonable rates also can be no more than speculation at this time. All of these arguments also will remain speculation until the administrative proceedings have been concluded by an agency order satisfying the findings requirements of the *Burlington* and *Hope* cases, *supra.*

Beyond this, Superior, Sun, and Hunt seek to overturn the agency's decision adopting area or group rates on constitutional and statutory grounds. The statutory arguments regarding group rate-making *per se* were not accepted by this Court in *Wisconsin* v. *Federal Power Commission, supra,* and need not be reconsidered. The constitutional arguments are premature because rates which might be attacked on these grounds have not been established with finality, and these producers have not availed themselves of the provisions for special exemption from area rates. This Court thus need not issue here advisory opinions on "a question of constitutional law in advance of the necessity of deciding it." *Peters* v. *Hobby,* 349 U.S. 331, 338 (1955).

For these reasons, none of the pending petitions should be granted, as none sets forth questions ripe for review or decided below in conflict with decisions of this Court. Development of sound procedures in group ratemaking will be harmed, not aided, if a reviewing

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ing costs and rate of return allowance, it could not determine whether the *unknown* actual rate of return allowance, and the *unknown* gas quality price adjustments imposed, are supported by substantial evidence. As to the second, the court did not require "automatic" stay, but held that notice must be given as to "guidelines" to be followed in "savings clause" proceedings, indicating only that, in the traditional sense, the Commission should grant stay for cause shown.

court sanctions an imperfect administrative effort. The decision of the court below permits elimination of gaps and defects in the administrative record and decision and permits expeditious conclusion of these proceedings, consistent with the requirement that an agency articulate and disclose the result of its rate orders. It is therefore unnecessary for this Court to proceed with but an interlocutory review of the Commission's area rate experiment in the skeletal and incomplete form now presented.

CONCLUSION

For the foregoing reasons, all petitions seeking a writ of certiorari to the Tenth Circuit in the Permian Basin Area Rate Case should be denied.

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June 1, 1967

APPENDIX A

Natural Gas Act, Section 19(b)

SECTION 19:

REHEARING; COURT REVIEW OF ORDERS

* * *

(b) Any party to a proceeding under this act aggrieved by an order issued by the Commission in such proceeding may obtain a review of such order in the circuit court of appeals of the United States for any circuit wherein the natural-gas company to which the order relates is located or has its principal place of business, or in the United States Court of Appeals for the District of Columbia, by filing in such court, within sixty days after the order of the Commission upon the application for rehearing, a written petition praying that the order of the Commission be modified or set aside in whole or in part. A copy of such petition shall forthwith be transmitted by the clerk of the court to any member of the Commission and thereupon the Commission shall file with the court the record upon which the order complained of was entered, as provided in section 2112 of title 28, United States Code. Upon the filing of such petition such court shall have jurisdiction, which upon the filing of the record with it shall be exclusive, to affirm, modify, or set aside such order in whole or in part. No objection to the order of the Commission shall be considered by the court unless such objection shall have been urged before the Commission in the application for rehearing unless there is reasonable ground for failure so to do. The finding of the Commission as to the facts, if supported by substantial evidence, shall be conclusive. If any party shall apply to the court for leave to adduce additional evidence, and shall show to the satisfaction of the court that such additional evidence is material and that there were reasonable grounds for failure to adduce such evidence in the proceedings before the Commission, the court may order such additional evidence to be taken before the Commission

and to be adduced upon the hearing in such manner and upon such terms and conditions as to the court may seem proper. The Commission may modify its findings as to the facts by reason of the additional evidence so taken, and it shall file with the court such modified or new findings, which if supported by substantial evidence, shall be conclusive, and its recommendation, if any, for the modification or setting aside of the original order. The judgment and decree of the court, affirming, modifying, or setting aside, in whole or in part, any such order of the Commission, shall be final, subject to review by the Supreme Court of the United States upon certiorari or certification as provided in [former] sections 239 and 240 of the Judicial Code, as amended (U.S.C., title 28, sec. 1254).

APPENDIX B

Administrative Procedure Act of 1946, Sections 8 and 10 as Recodified by P.L. 89-554, 80 Stat. 378 (1966)

§ 557. Initial decisions; conclusiveness; review by agency; submissions by parties; contents of decisions; record

(a) This section applies, according to the provisions thereof, when a hearing is required to be conducted in accordance with section 556 of this title.

(b) When the agency did not preside at the reception of the evidence, the presiding employee or, in cases not subject to section 554(d) of this title, an employee qualified to preside at hearings pursuant to section 556 of this title, shall initially decide the case unless the agency requires, either in specific cases or by general rule, the entire record to be certified to it for decision. When the presiding employee makes an initial decision, that decision then becomes the decision of the agency without further proceedings unless there is an appeal to, or review on motion of, the agency within time provided by rule. On appeal from

or review of the initial decision, the agency has all the powers which it would have in making the initial decision except as it may limit the issues on notice or by rule. When the agency makes the decision without having presided at the reception of the evidence, the presiding employee or an employee qualified to preside at hearings pursuant to section 556 of this title shall first recommend a decision, except that in rule making or determining applications for initial licenses—

(1) instead thereof the agency may issue a tentative decision or one of its responsible employees may recommend a decision; or

(2) this procedure may be omitted in a case in which the agency finds on the record that due and timely execution of its functions imperatively and unavoidably so requires.

(c) Before a recommended, initial, or tentative decision, or a decision on agency review of the decision of subordinate employees, the parties are entitled to a reasonable opportunity to submit for the consideration of the employees participating in the decisions—

(1) proposed findings and conclusions; or

(2) exceptions to the decisions or recommended decisions of subordinate employees or to tentative agency decisions; and

(3) supporting reasons for the exceptions or proposed findings or conclusions.

The record shall show the ruling on each finding, conclusion, or exception presented. All decisions, including initial, recommended, and tentative decisions, are a part of the record and shall include a statement of—

(A) findings and conclusions, and the reasons or basis therefor, on all the material issues of fact, law, or discretion presented on the record; and

(B) the appropriate rule, order, sanction, relief, or denial thereof.

* * *

§ 704. Actions reviewable

Agency action made reviewable by statute and final agency action for which there is no other adequate remedy in a court are subject to judicial review. A preliminary, procedural, or intermediate agency action or ruling not directly reviewable is subject to review on the review of the final agency action. Except as otherwise expressly required by statute, agency action otherwise final is final for the purposes of this section whether or not there has been presented or determined an application for a declaratory order, for any form of reconsideration, or, unless the agency otherwise requires by rule and provides that the action meanwhile is inoperative, for an appeal to superior agency authority.



PETITION FOR A WRIT OF CERTIORARI

APR 19 1967
JOHN F. DAVIS, CLERK

In the

Supreme Court of the United States

OCTOBER TERM, 1966

No. ~~1294~~ 101

HUNT OIL COMPANY, *et al.*,
Petitioners,

v.

FEDERAL POWER COMMISSION,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

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CARD 18

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v.

FEDERAL POWER COMMISSION,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

Petitioners Hunt Oil Company, H. L. Hunt, Lamar Hunt, N. B. Hunt, W. H. Hunt, Secure Trusts, Caroline and Loyd B. Sands, Caroline Hunt Trust Estate, Lyda Hunt-Caroline Trusts, Lyda Hunt-Bunker Trusts, Lyda Hunt-Lamar Trusts, Lyda Hunt-Herbert Trusts, Lyda Hunt-Margaret Trusts (Formerly Estate of Lyda Bunker Hunt, Deceased), Hunt Industries (Formerly Estate of Lyda Bunker Hunt, Deceased) and Placid Oil Company, hereinafter referred to as Hunt, *et al.*, pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Tenth Circuit entered in the above entitled case on January 20, 1967.

OPINIONS BELOW

The opinion of the court of appeals is reported at ..... F. 2d ....., and is printed in the Superior Oil Company's Petition for Certiorari, Appendix B, beginning at page 9a. The opinion and orders of the Federal Power Commission (J.A. 516d-826d, 1105d-1132d, 1154d-1157d) are reported at 34 FPC 159, 34 FPC 1063 and 34 FPC 1198.

JURISDICTION

The judgment of the Court of Appeals for the Tenth Circuit was entered on January 20, 1967, and is printed in the Superior Oil Company Petition for Certiorari, Appendix B, on page 60a. On February 8, 1967, the court of appeals extended for a period of 30 days the time for petitioning for rehearing. Producer parties in several companion cases filed petitions for rehearing. The jurisdiction of this Court is invoked under 28 U.S.C. Section 1254(1) and Section 19(b) of the Natural Gas Act, 15 U.S.C. §717r(b).

QUESTIONS PRESENTED

I. Whether the method adopted by the Commission of fixing area *ceiling* rates at the *average* composite cost level of a selected group of companies, without regard to any other factors, meets the Constitutional requirement of assuring producers non-confiscatory rates, meets the statutory requirement that all rates shall be just and reasonable and assures consumers the low-

est reasonable rates consistent with the maintenance of adequate service when:

(1) the record shows average test year revenues of only 13.05¢ per Mcf for gas-well gas and only 12.72¢ per Mcf for all test year gas sales (R. 33006) and the Commission found test year costs of 14.39¢ per Mcf for flowing gas (R. 277655) and 16.43¢ per Mcf for gas-well gas (R. 277606),

(2) only 16 of the 44 producer respondents (as revealed by the workpapers underlying Schedule 3 of Staff Exhibit 170 upon which the Commission relied) whose costs were used to compute the average cost of flowing gas will realize the 12% return found appropriate by the Commission,

(3) the Commission found that the small producers are essential to the welfare of the consumers (R. 277687) and they are the ones who will receive little or no return,

(4) the consumers are required to pay for all costs incurred whether 1¢ or $10 per Mcf, but instead of reimbursing the producers who actually incurred such costs, the producers whose costs were below the average would not only be reimbursed for actual cost incurred but in addition would be given a bonus equal in the aggregate to the costs incurred by other producers in excess of the average,

(5) the consumers under the area method will be required to pay millions of dollars more in rates (that is unit cost exceeds contract prices of many producers) than would be required under the individual company cost of service method assuming the same rate of return for individual producers as allowed for the group,

(6) the two-price system will make future cost determinations of flowing gas administratively infeasible if not absolutely impossible (due to the data collection and allocation problems).

II. Whether in fixing area rates on the basis of average composite costs of a selected group of companies under the just and reasonable standard of the Natural Gas Act and having due regard for the Constitutional prohibition against confiscation, the Commission can:

(1) reduce the rate or require refunds of any producer when average group costs exceed average group revenues, or

(2) reduce the rate or require refunds of a producer when such producer's prudently incurred company wide cost exceeds its company wide revenue.

III. Whether the Natural Gas Act and the Constitution will permit the Commission to impose uniform ceiling rates on all producers in an area regardless of the impact on such producers in such area or in the Continental U. S. when:

(1) the sole basis for the uniform ceiling rate is the average composite cost of a selected group of producers,

(2) no finding has been made either

(a) that the average cost of the group is typical of the average cost of the individual producers, or

(b) that the composite operations of the group are typical of the operations of the individual producers, and

(3) the dispersion of costs between individual companies as shown by the Commission's own Staff Exhibit No. 174 (R. 32963-33000) is so wide or so great as to demonstrate *per se* that the average cost could not be typical of the various companies' costs.

IV. Whether the end result test and impact of the rate order can be determined without considering the propriety of figures and formulas used to arrive at the composite cost and without considering the effect of the ceiling rate on individual producers or on producers as a group in the area or in the Continental United States.

STATUTES INVOLVED

The statutory and Constitutional provisions involved are Sections 4 and 5 of the Natural Gas Act, 15 U.S.C. 717c and 717d and the Fifth Amendment to the Constitution of the United States. The pertinent parts are as follows:

Section 4(a), 15 U.S.C. 717c(a)

> "Sec. 4. (a) All rates and charges made, demanded, or received by any natural-gas company for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges, shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful."

Section 4(e), 15 U.S.C. 717c(e)

> "(e) Whenever any such new schedule is filed the Commission shall have authority, either upon complaint of any State, municipality, State commission, or gas distributing company or upon its own initiative without complaint, at once, and if it so orders, without answer or formal pleading by the natural-gas company, but upon reasonable notice, to enter

upon a hearing concerning the lawfulness of such rate, charge, classification, or service; and, pending such hearing and the decision thereon, the Commission, upon filing with such schedules and delivering to the natural-gas company affected thereby a statement in writing of its reasons for such suspension, may suspend the operation of such schedule and defer the use of such rate, charge, classification, or service, but not for a longer period than five months beyond the time when it would otherwise go into effect; and after full hearings, either completed before or after the rate, charge, classification, or service goes into effect, the Commission may make such orders with reference thereto as would be proper in a proceeding initiated after it had become effective. If the proceeding has not been concluded and an order made at the expiration of the suspension period, on motion of the natural-gas company making the filing, the proposed change of rate, charge, classification, or service shall go into effect. Where increased rates or charges are thus made effective, the Commission may, by order, require the natural-gas company to furnish a bond, to be approved by the Commission, to refund any amounts ordered by the Commission, to keep accurate accounts in detail of all amounts received by reason of such increase, specifying by whom and in whose behalf such amounts were paid, and upon completion of the hearing and decision, to order such natural-gas company to refund, with interest, the portion of such increased rates or charges by its decision found not justified. At any hearing involving a rate or charge sought to be increased, the burden of proof to show that the increased rate or charge is just and reasonable shall be upon the natural-gas company, and the Commission shall give to the hearing and decision of such questions preference over other questions pending before it and decide the same as speedily as possible."

Section 5(a), 15 U.S.C. 717d(a)

"Sec. 5. (a) Whenever the Commission, after a hearing had upon its own motion or upon complaint of any State, municipality, State commission, or gas distributing company, shall find that any rate, charge, or classification demanded, observed, charged, or collected by any natural-gas company in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force and shall fix the same by order: *Provided, however*, That the Commission shall have no power to order any increase in any rate contained in the currently effective schedule of such natural-gas company on file with the Commission, unless such increase is in accordance with a new schedule filed by such natural-gas company; but the Commission may order a decrease where existing rates are unjust, unduly discriminatory, preferential, otherwise unlawful, or not the lowest reasonable rates."

Amendment 5, United States Constitution

"No person shall be held to answer for a capital, or otherwise infamous crime, unless on a presentment or indictment of a Grand Jury, except in cases arising in the land or naval forces, or in the Militia, when in actual service in time of War or public danger; nor shall any person be subject for the same offence to be twice put in jeopardy of life or limb; nor shall be compelled in any criminal case to be a witness against himself, nor be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation."

STATEMENT

This case involves the Federal Power Commission's first attempt to fix just and reasonable rates for independent producers on an area basis.

The first major producer rate case to reach the Commission on the merits was the original *Phillips* Case, 24 FPC 537 (1960) on remand from the Supreme Court, *Phillips Petroleum Co. v. State of Wisconsin*, 347 U.S. 672 (1954). While utilizing individual company cost of service to pass upon a number of increased rate filings in such case, the Commission concluded that the individual company utility type cost of service approach was not appropriate for fixing just and reasonable producer rates for the future. This case is a direct outgrowth of that conclusion. (R. 277575)

The jurisdiction of the court of appeals was invoked under Section 19(b) of the Natural Gas Act, 15 U.S.C. §717r(b).

The hearing before the Commission consumed 258 actual hearing days (including prehearing conferences) during which time 337 main exhibits and numerous supplemental exhibits were received. The transcript consists of more than 30,000 pages.

The Commission refused to receive evidentiary data relating to individual companies (R. 269879). As a result, the Examiner's Decision, the Commission's Opinion and the court decision below are based solely upon consideration of selected group data on an area basis. The Commission issued questionnaires (Appendices A, B and C) for the purpose of gathering costs and drilling data from the Permian Basin Area

producers (R. 270235, 272688, 273253). The Appendix C cost questionnaires were sent to approximately 350 small producers but only 105 responded. This data was completely ignored (R. 277647, 277648). The Appendix B cost questionnaires designed for major producers were completed by 68 producers, 43 having more than 10,000,000 Mcf of test year sales and 25 having less. The Commission relied exclusively on the Appendix B data for its determination of the cost of flowing gas (R. 277647-648). However, data of only 44 of the 68 producers were included in the Commission's cost computation.[1]

The Appendix A questionnaires were sent to all of the 336 producer respondents. Of this number, 240 were completed in a usable manner (R. 275174). This data was used to a limited extent in computing the cost of new gas-well gas, but not the cost of flowing gas.

Ceiling rates were prescribed for more than 1400 producers operating in the Permian Basin area (R. 920) of which only 336 were named as party respondents (R. 277567). Another 2610 gas producers sell gas for processing in plants (R. 17527) and would be subject to the ceiling rates. The Commission prescribed two ceiling rates, one for new gas-well gas and one for flowing gas. New gas-well gas was defined as non-associated gas produced from dry gas reservoirs,

[1] The Commission relied upon its Staff's composite cost of service presentation (R. 277645), found that "the production expense and investment data for gas-well leases which cover some two-thirds of the gas-well gas produced in the area is fully representative of the cost for gas-well gas" (277788), and computed the cost from the data of the three gas lease classifications set forth in Exhibit No. 170, Schedule 3 (R. 32892). The underlying workpapers reveal that only 44 of the 68 producers had gas production in these three gas lease categories.

gas condensate reservoirs and gas from gas cap wells and residue gas derived therefrom sold under contracts executed on or after January 1, 1961 (R. 277601, 277636). Flowing gas was defined as all casinghead gas and residue gas derived therefrom both old and new and old gas-well gas and residue gas derived therefrom (R. 277660). Old gas-well gas is gas delivered under contracts entered into prior to January 1, 1961 (R. 277601). In each case, the Commission used an average composite cost from selected data as the measure of the price (R. 277602 and R. 277645).

The *ceiling* rate for new gas-well gas was fixed at the computed or estimated *average* cost level of finding and producin gas (R. 277604) by using a variety of so-called industry wide data gathered by various organizations, governmental agencies and private concerns for purposes wholly unrelated to the determination of just and reasonable rates.

The *ceiling* rate for flowing gas was fixed at the *average* historical composite cost level (R. 277645) of a selected group of companies. The flowing gas cost was determined by using a combination of Permian Basin area data for production costs (R. 277645-277646) and national data for exploration and development cost (R. 277651) and adding regulatory expense and state production taxes.

Both the new gas-well gas and flowing gas ceiling prices were made subject to quality adjustments. In each case the ceiling rate was to be reduced by an amount equivalent to the cost to the purchaser of bringing the gas up to specified standards. The record does not contain data that would

enable the Commission or the courts to determine the effect of the quality adjustments and the court below remanded the case to the Commission for such additional hearings as might be needed to determine the effect of the quality adjustments and to determine group revenue and group revenue requirements (costs).

The ceiling rates were to apply on a contract-by-contract basis regardless of the cost of the gas involved, the field unit cost, the area or company wide cost of the producer, the time period in which the gas was discovered and developed, the depth of the reservoir or any other factor. The Commission also ordered refunds on a contract-by-contract basis of all amounts collected under Section 4(e) proceedings in excess of the ceiling rates without determining whether there were individual or group revenue deficiencies for prior periods and regardless of any other considerations.

Petitioners and other producers filed petitions for review in the Tenth Circuit challenging the lawfulness of the rates fixed, the denial of the right of individual producers to submit evidence showing their individual revenue requirements (costs), and the ordering of refunds.

The Court of Appeals for the Tenth Circuit issued its decision on January 20, 1967, reversing the Commission's Opinions 468 and 468-A in part and remanding such matters to the Commission for further proceedings. Essentially the remand directed the Commission to (1) hold such additional hearings as are needed to determine the effect of the quality adjustments and to determine the group revenues and group

revenue requirements, (2) make appropriate findings on the above matters, and (3) include in its new order an adequate provision for special relief for individual producers. However, the court of appeals affirmed the Commission's order in the following respects:

(1) The Commission's action in fixing *ceiling* rates at the *average* composite cost level of a selected group of Respondents.

(2) The Commission's failure to determine whether or not the average composite cost determined was typical of either the group of producers whose cost was used or any of the remaining producers.

(3) The Commission's failure to determine whether or not the composite operations of such producers was typical of the group or any member of the group, or any of the remaining producers.

(4) The Commission's failure to receive evidence relating to individual producers and to consider the import or consequences of its rate order upon the individual producers.

(5) The Commission action in ordering refunds of all amounts collected in excess of the ceiling rates on a rate schedule by rate schedule basis without regard to the cost or revenue requirements of the individual producer or the group.

REASONS FOR GRANTING THE WRIT

1. Clearly the questions presented are of the utmost importance in the administration of the Natural Gas Act. Six years after this Court held that independent producers were subject to the jurisdiction of the Federal Power Commission

under the Natural Gas Act, *Phillips Petroleum Co. v. State of Wisconsin*, 347 U.S. 672 (1954), the Commission in deciding its first major producer rate case, *Phillips Petroleum Company*, 24 FPC 537, held that regulating independent producers on an individual company basis was neither logical nor workable and announced its intention of regulating the sales of independent producers on an area basis. The Commission's decision in the *Phillips* case was affirmed by this Court in *Wisconsin v. Federal Power Commission*, 373 U.S. 294 (1963). Since this is the Commission's first effort at regulating rates on an area basis and since this decision, if allowed to stand, will be a controlling precedent in the determination of area rates in all other areas of the United States, the importance of the questions presented can only be measured by the importance of natural gas as a source of energy to consumers throughout the nation. A wrong decision here could very well jeopardize the adequate future supply of gas. Consequently, this case is perhaps more important than all of the other producer cases that have come before this Court.

2. The decision of the court below is in error and in conflict with applicable decisions of this Court.

The decision below conflicts with *Atlantic Refining Company v. Public Service Commission of New York*, 360 U.S. 378 (1959) and *United Gas Improvement Co. v. Callery Properties, Inc.*, 382 U.S. 223 (1965), in that rates fixed on the basis of composite cost do not provide for the lowest reasonable rate consistent with the maintenance of adequate service. This record clearly shows that the unit cost of gas of

many individual companies clearly exceeds the maximum price permitted by their contracts. Regardless of whether rates are fixed on an area or individual company basis, such companies would not be permitted rates in excess of their contract prices. However, the Commission's area rate method affirmed by the court below will result in consumers reimbursing producers for all incurred costs including such costs which are in excess of contract prices. However, the consumers' dollars will not go to the producers who incurred such cost in excess of the average but to producers whose costs are less than the average.

While the Commission held that:

> "Consumers and the natural gas industry alike have a strong stake in the continuation of the exploration efforts of the thousands of small operators, who contribute a large share of the discoveries of new surfaces of gas." (R. 277687)

and that:

> "A return of 12 percent on production activities protects gas consumers * * * It also considers the needs of the smaller independent who traditionally drills much of the Permian exploratory footage and his limited resources to weather even a brief series of unproductive expenditures." (R. 277628),

the ceiling prices actually imposed will deny all except 16 of the producers whose data was considered the 12 percent rate of return held to be appropriate. Only 26 producers (including the 16 who earned 12 percent or more) will earn any return.[2] Thus, not only does the decision conflict with the

[2] Workpapers underlying Staff Witness Fisher's Exhibit No. 170 upon which the Commission computed the flowing gas cost.

requirements of *CATCO* and *Callery*, *supra*, but the end result is inconsistent with the findings of the Commission upon which the result is based.

The decision below is in conflict with *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591 (1944) and *Colorado Interstate Gas Company v. Federal Power Commission*, 324 U.S. 581, (1954) in that rates fixed on the basis of composit average costs do not permit the majority of regulated companies to recover their expenses and earn a reasonable rate of return on investments to the extent their contracts permit. Therefore, the end result is unjust and unreasonable in its consequences. Although the court below held at page 60 that from the standpoint of the producers "it is entitled to recover its prudent operating expenses and capital costs with a return commensurate to the risk and sufficient to attract capital," it upheld the Commission's two-price average composite cost method which results in denying *all but 16 producers* whose costs were considered an opportunity to recover such costs. Since the composite cost of the flowing gas was based upon the data of *44 of* the larger producers (R. 277647, 277648) and since the record reveals that smaller producers as a rule have higher costs than the larger producers (R. 277714) few, if any, of the remaining producers could be expected to recover such costs. Although the court below noted that the Commission "refused to receive individual cost figures" (Slip Opinion, page 37) and although no party suggested that any of the costs were imprudently incurred, the court did not include its its remand a provision requiring the

Commission to allow each producer an opportunity to recover prudent costs actually incurred to the extent its contracts permit. On the contrary, the court passed it off as being characteristic of group rate making, stating:

> "It is self-evident that when average costs are used to compute ceiling prices, the high cost operator will be hurt and some low cost operators may receive windfalls." Slip Opinion, p. 61

In so doing the court relied upon *Acker v. United States*, 298 U.S. 426, 431 (1936), dealing with "extravagant or unnecessary costs" and *Tagg Brothers v. United States*, D.C. Neb. 29 F. 2d 750, 755, affirmed 280 U.S. 420, (1930) concerning rates high enough to enable all agencies to make money. Obviously, these cases are inapplicable because neither the Commission nor the court has determined that any of the costs are extravagant, unnecessary or imprudently incurred and the contract limitations will preclude any company from collecting excessively high rates.

The failure of the Commission and the court below to consider the impact on individual producers of ceiling rates fixed at average composite cost levels is also inconsistent with this Court's holdings in *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591, 603 (1944), *Colorado Interstate Gas Company v. Federal Power Commission*, 209 F. 2d 717, 724 (10th Cir. 1953) reversed on other grounds, *sub nom. Federal Power Commission v. Colorado Interstate Gas Company*, 348 U.S. 492 (1955), *United Gas Pipe Line Company v. Memphis Gas, Light and Water Division*, 358 U.S. 103, 113-114 (1958), and *Wisconsin v.*

Federal Power Commission, 373 U.S. 294, 309-310 (1963), all of which hold that the economic needs of the natural gas companies must be considered.

The Commission's order requiring refunds affirmed by the court below, of amounts collected in excess of the ceiling rates irrespective of whether the group or the individual company ordered to make the refund experienced a revenue deficiency during the period involved is inconsistent and in direct conflict with this Court's holding in *Wisconsin v. Federal Power Commission*, 373 U.S. 294, 306 (1963) wherein it stated:

> "Having decided on the basis of substantial evidence that the increases did not bring revenues up to cost of service the Commission properly concluded on the only matter before it with respect to these dockets that *no refund obligation could be imposed.*" *(Emphasis added)*

The decision below is also in error and in conflict with *United States v. Abilene and Southern Railway Company*, 265 U.S. 274, 291 (1924) and *Interstate Commerce Commission v. Mechling*, 330 U.S. 567, 583, (1947) in that the Commission's area method was upheld without any consideration or determination of whether the composite cost or composite operations were typical of either the group or of the companies making up the group. While accepting "the principle that both the basic figures and the averages obtained therefrom must be typical and representative" (Slip Opinion, p. 61) the court below merely stated that it was convinced that the Commission had not mis-

used its expertise in this field. The court did not cite any evidence or Commission finding to support this assumption nor could it because neither the Examiner nor the Commission made any effort to determine this issue nor the impact of the area ceilings upon individual producers. On the contrary, by refusing to receive individual company data and by collecting cost data without regard to fields, depths, time of discovery and development or any other matter, the Commission effectively precluded any consideration of whether the composite data was representative or typical of the data or operations of the individuals who will be subject to the area ceilings.

CONCLUSION

WHEREFORE, for the foregoing reasons, this Petition for Writ of Certiorari should be granted.

Respectfully submitted,

PAUL W. HICKS,
Counsel for Petitioners.

April 20, 1967

PETITION FOR A WRIT OF CERTIORARI

APR 19 1967

JOHN F. DAVIS, CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1966

No. [redacted] 102

PACIFIC GAS AND ELECTRIC COMPANY,
PACIFIC LIGHTING SERVICE AND SUPPLY COMPANY,
SAN DIEGO GAS & ELECTRIC COMPANY,
SOUTHERN CALIFORNIA GAS COMPANY and
SOUTHERN COUNTIES GAS COMPANY OF CALIFORNIA,

Petitioners,

vs.

SKELLY OIL COMPANY, et al.,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1966

No. .....

PACIFIC GAS AND ELECTRIC COMPANY,
PACIFIC LIGHTING SERVICE AND SUPPLY COMPANY,
SAN DIEGO GAS & ELECTRIC COMPANY,
SOUTHERN CALIFORNIA GAS COMPANY AND
SOUTHERN COUNTIES GAS COMPANY OF CALIFORNIA,
Petitioners,

v.

SKELLY OIL COMPANY, *et al.*,
Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

Petitioners, Pacific Gas and Electric Company, Pacific Lighting Service and Supply Company, San Diego Gas & Electric Company, Southern California Gas Company and Southern Counties Gas Company of California, pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Tenth Circuit, entered in the above case on January 20, 1967.[1]

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[1] The decision of the Court of Appeals involved thirty-two different petitions for review. The respondents to the petition other than Skelly Oil Company are Phillips Petroleum Company; Warren Petroleum Corporation; Mobil Oil Corporation (form-

erly Socony Mobil Oil Company, Inc.); Pan American Petroleum Corporation; Northern Natural Gas Producing Company; Standard Oil Company of Texas, a Division of Chevron Oil Company; Texaco Inc.; Hunt Oil Company jointly with H. L. Hunt, Lamar Hunt, N. B. Hunt, W. H. Hunt, Secure Trusts, Caroline and Loyd B. Sands, Caroline Hunt Trust Estate, Lyda Hunt-Caroline Trusts, Lyda Hunt-Bunker Trusts, Lyda Hunt-Lamar Trusts, Lyda Hunt-Herbert Trusts, Lyda Hunt-Margaret Trusts (formerly Estate of Lyda Bunker Hunt, Deceased), Hunt Industries (formerly Estate of Lyda Bunker Hunt, Deceased), and Placid Oil Company; Humble Oil & Refining Company; Shell Oil Company; The Atlantic Richfield Company (formerly The Atlantic Refining Company) jointly with Dorchester Gas Producing Company, Southland Royalty Company, and Westates Petroleum Company; Continental Oil Company jointly with Sunray DX Oil Company, Sinclair Oil & Gas Company, Cabot Corporation, Sohio Petroleum Company, Joseph E. Seagram & Sons, Inc., Joseph E. Seagram & Sons d/b/a Texas Pacific Oil Company, Gulf Oil Corporation, Murphy Oil Corporation, The Nueces Company, Samedan Oil Corporation, Cities Service Oil Company (formerly Cities Service Petroleum Corporation), Cities Service Production Company (now merged with Cities Service Oil Company), Columbian Fuel Corporation, Amerada Petroleum Corporation, Union Oil Company of California and as Successor to The Pure Oil Company, Tidewater Oil Company, Reef Corporation, and William A. & Edward R. Hudson, Joint Operators; Marathon Oil Company; Sun Oil Company; Independent Petroleum Association of America; The British-American Oil Producing Company; Union Texas Petroleum, a Division of Allied Chemical Corporation; Midhurst Oil Corporation; The Superior Oil Company; Perry R. Bass jointly with Panther City Investment Co., Bass Bros. Enterprises, Inc., Perry R. Bass, Incorporated, and Richardson Oils, Inc.; Columbian Carbon Company jointly with Coltexo Corporation; The State of Texas; Big Chief Drilling Company jointly with King-Stevenson Oil Company, Inc., and Service Drilling Company; Texas Independent Producers and Royalty Owners Association jointly with West Central Texas Oil and Gas Association; State of New Mexico; Gulf Oil Corporation; Amerada Petroleum Corporation; and J. C. Barnes, et al.

CITATIONS TO OPINIONS BELOW

The Opinion of the Federal Power Commission is reported in 34 F.P.C. 159, and is printed in Appendix A hereto, pp. 1-333. On rehearing, the Commission modified its Opinion. Its modified Opinion is reported in 34 F.P.C. 1068, and is printed in Appendix A hereto, pp. 347-377. The Opinion of the Court of Appeals is as yet unreported, and is printed in Appendix A hereto, beginning at p. 382.[2]

JURISDICTION

The judgment of the Court of Appeals was entered on January 20, 1967. The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1) and 15 U.S.C. §717r(b).

QUESTIONS PRESENTED

1. Must the Federal Power Commission, under the Natural Gas Act (15 U.S.C. 717, *et. seq.*), establish area gas rates to allow recovery of the industry's "cost of service" when according to the Commission such a cost of service would include expense items substantially in excess of the actual cost of the gas subject to the rate order?

2. Whether in view of this Court's decision in *Mobile*[3] and in *Sierra*[4] the Federal Power Commision's rate order

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[2] Because of the length of the Opinions below, they have been printed and bound in a separate volume.

[3] United Gas Pipe Line Co. v. Mobile Gas Corp., 350 U.S. 332 (1956).

[4] Federal Power Com. v. Sierra Pacific 350 U.S. 348 (1956).

is unlawful because it did not abrogate all producer contracts with prices below the applicable area rates found by the Commission to be just and reasonable to permit all producers to recover such rates?

3. Whether the Federal Power Commission need, at this time, in an area rate case establish detailed administrative procedures for individual producer relief, including provisions for a stay of the entire general rate order?

4. Whether the Federal Power Commission's Opinion No. 468 is a lawful and enforceable order of the Commission?

STATUTE INVOLVED

The statutory provisions involved are Sections 4 (15 U.S.C. §717c), 5 (15 U.S.C. §717d), and 19 (15 U.S.C. §717r) of the Natural Gas Act. They are printed in Appendix B hereto, p. 432.[5]

STATEMENT

This Court is already familiar with the background which led to the Federal Power Commission's first area rate decision, which has now been remanded by the Court of Appeals. It is recited in full in Mr. Justice Harlan's Opinion in *Wisconsin v. Federal Power Commission*, 373 U.S. 294, 295-302 (1963), hereafter referred to as *Second Phillips*, and the facts there set forth need not all

[5] The appropriate provisions of the Natural Gas Act have been printed and bound with the Opinions below.

be repeated here except to state that the Commission's decision had its genesis in *Phillips Petroleum Co. v. Wisconsin*, 347 U.S. 672 (1954).

This Court will recall that following the remand in *Phillips Petroleum Co., supra* (which charged the Commission with the duty to regulate rates charged by the natural gas producers), the Commission reinstated its investigation of Phillips Petroleum Company's natural gas rates; and following extensive hearings, briefs and arguments, concluded:

> ". . . that the individual company cost-of-service method, based on theories of original cost and prudent investment, was not a workable or desirable method for determining the rates of independent producers and that the 'ultimate solution' lay in what has come to be known as the area rate approach: 'the determination of fair prices for gas, based on reasonable financial requirements of the industry' for each of the various producing areas of the country."[6]

Following its decision in *Second Phillips, supra,* the Commission set down its first area rate case on December 23, 1960. It was to encompass an oil and gas producing area known as the Permian Basin which the Commission characterized as "one of the nation's great oil and gas provinces."[7] This Basin is located in southeastern New Mexico and western Texas. It forms the most important natural gas supply area for Petitioners.

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[6] Second Phillips, *supra,* 373 U.S. at 298-299.

[7] Opinion No. 468, p. 1 (J.A. 529d, R. 277567).

Together these Petitioners serve natural gas to over five million individual homes and businesses in their respective service areas in California, which are inhabited by over 90 percent of the State's total population of nineteen million persons. These companies are vitally interested in the outcome of this proceeding because about 65 percent of their total natural gas supply comes from pipelines whose major source of natural gas is in the Permian Basin area. Physically, nearly all the gas involved in this proceeding flows westward to markets in California or smaller markets along the way. This supply of natural gas, *its price and the stability of that price* are of critical importance to Petitioners and their natural gas consumers.

Actual hearings in the Permian proceeding commenced on October 11, 1961, and concluded on September 12, 1963. Two hundred fifty-one hearing days were involved, and the hearing transcript covers 30,230 pages. Three hundred thirty-seven exhibits were introduced by the parties. The matter was then submitted to a hearing examiner of the Federal Power Commission who rendered his decision on September 17, 1964. Following briefs on exceptions, oral argument was heard by the full Commission beginning on February 8, 1965. On August 5, 1965, the Commission issued its opinion. Following petitions for rehearing, the Commission issued Opinion No. 468-A on October 4, 1965, denying applications for rehearing, but modifying its initial opinion where it deemed appropriate.

We participated extensively in the proceeding by presenting evidence, cross-examination, briefing and argu-

ment. Much of the evidence we sponsored formed the basis of the Commission's ultimate decision.

On September 13, 1965, Skelly Oil Company petitioned for review by the Court of Appeals for the Tenth Circuit, and other respondent producers followed suit. Petitioners intervened and actively participated by brief and argument. On January 20, 1967, the Court of Appeals issued its opinion remanding the Commission's decision for further proceeding in accordance with that opinion. On February 1, 1967, the Federal Power Commission announced it intended to request the Solicitor General to seek Supreme Court review of the Court of Appeals decision on behalf of the Commision. Between March 6 and March 10, 1967, a number of respondent producers petitioned the Court of Appeals for rehearing on a limited number of issues.

REASONS FOR GRANTING THE WRIT

1. The Remand Ordered by the Court Below Would Result in Fruitless and Unnecessary Delay of Producer Regulation.

The Court of Appeals upheld the basic framework of the method of regulation adopted by the Commission. In doing so it approved the area method of regulation, the two price system adopted by the Commission, the cutoff date proposed, and the moratorium on price increases, all essential to the effectiveness of the Commission's action. It nevertheless remanded to the Commission for further proceedings, the matters encompassed in our statement of questions presented.

Review by this Court is necessary to avoid such a remand, which will fruitlessly enlarge the delay already lasting 13 years in the Commission achieving the goal of this Court's mandate in *Phillips Petroleum Company, supra,* to effectively regulate producers rates. Indeed, the entire question of the proper regulation of producer prices under the Natural Gas Act must in any event ultimately reach this Court. The orderly administration of the Natural Gas Act and the imperative need for the earliest possible protection of the gas consumers would seem to require that the date for a definite decision from this Court be delayed no longer. *Atlantic Ref. Co. v. Public Serv. Com.,* 360 U.S. 378 (1959). The Commission has long struggled with the duty imposed upon it to regulate producer rates. The history of this struggle can be read in the decisions of this Court in the years since 1954 which have arisen from Commission action. And now, in this case, the Commission has come forward with the method of regulation which not only satisfies its conception of the requirements of the Natural Gas Act, but in large measure satisfies the requirements of the Court below.

The Commission's opinion opened with:

> "This is the first area proceeding to determine just and reasonable rates for natural gas producers. It is the culmination of an effort initiated more than four and a half years ago, and which has been carried forward with the greatest sense of urgency on the part of all concerned." 34 FPC at 171, J.A. 529d, R277, 568.

This sense of urgency was the result of the recognition by all concerned, including the Commission, that this case was the most important one to be heard by the Commission since it was impressed with the duty to regulate the rates of independent producers. The interim efforts of the Commission in attempting to fulfill this duty have been heard by this Court. This decision is of far greater importance than the interim decisions already heard, and it is, therefore, most certainly worthy of this Court's immediate consideration.

The effect of the Court's remand of the Commission's decision can best be described by the following quotation from this Court's opinion in *Second Phillips, supra.*

> "Such a remand undoubtedly would have consumed considerable time and energy, including that of the Commission and its staff, and would almost certainly have involved another decision by a hearing examiner, another appeal to the Commission, another petition for rehearing and further judicial review of complex and difficult issues. In short, the alternative rejected by the Commission would not have resulted in definitive regulation of Phillips' rates immediately or in the near future. Indeed, several years might have elapsed before even the method of regulation which the Commission regards as unsuitable would have become effective as to even this one producer." (373 U.S. at 311-312)

We urge this Court to immediately grant this writ of certiorari (even though there may be petitions for rehearing pending in the Court below) in order to completely review the *entire* decision so that the uncer-

tainty in this important regulatory area can be brought to a prompt end. To not grant this writ before the end of the current term of the Court will delay ultimate resolution for another year. Continued delay will seriously hamper effective regulation.

2: The Rate Order Adopted by the Commission is Not Unlawful.

(a) There Has Been No Showing that the Commission's Rate Order Will Not Permit Revenues Adequate to Recover the Producers' Actual Cost of Gas Sold.

The Court below, in the absence of any showing that the actual cost of the gas being sold by the producers exceeded the allowed rates, either individually or as a group, concluded that the rate order was unlawful because the Commission did not specifically find that its applicable rates, including quality adjustments, would recover the total "cost of service" of the producers as a group. The "cost of service" includes not only the cost of production but also the cost of finding new reserves and additional reserves to meet estimated future demands. The Commission in discussing these items of cost said in respect to the bulk of the gas subject to the rate order:

> "While the cost of residue gas cannot be found with the precision requisite to serve as a basis for fixing ceiling prices, the evidence in the record makes clear that with respect to casinghead gas and residue gas derived therefrom (which together make

up by far the largest share of the Permian gas subject to quality adjustments) the costs are substantially below the 14.5 cents per Mcf ceiling price. For one thing the price includes a 4.08 cents allowance for exploration and development expense even though such gas was largely found as a by-product of the search for oil. For another, there would be no reason to allow producers a 12 percent rate of return on their investment for processing residue gas since the investment in processing plants and equipment is subject to few of the special risks incurred by those who explore for and develop reserves of gas.

"We do not mean to suggest that the E&D allowance and the profit which we have provided for flowing gas is not fully justified, but we believe it is relevant to point out that these two items, which account for 9.0 cents of the 14.5 cents price for flowing gas, are based in part on justifications other than cost, and provide ample allowance for the risk that low-quality gas in the area may not command the full area price." (Opinion No. 468A, p. 6; J.A. 1112d-1113d, R278, 709-R278, 710)

The court below completely ignored the above finding and statement of the Commission and ignored its own following observation:

"We agree with the Commission that the expense items included in an individual cost-of-service are not the measure of a confiscatory rate. A producer has no constitutional right to be reimbursed for

> dry-hole expenses. Also it has no obligation to remain in business by replenishing the supplies of gas which form the basis of present obligations. Inability to continue exploration and development is not confiscation. We conclude that the impact of the Permian rates on the high cost producers does not destroy the area rate method. (Appendix A, p. 416-417)

Not only has there been no showing of confiscation, but the record before the Commission and above quoted statement of the court below establishes that rates fixed on the basis of "cost of service" are above the actual costs of gas sold.

We do not mean to suggest, as the Commission in the above quotation did not mean to suggest, that it is either improper or not in the public interest to provide for an adequate exploration allowance to replace gas sold and obtain additional reserves. However, we do suggest that the rates established by the rate order cannot be held to be unlawfully low merely because the Commission did not specifically find that such rates would permit the recovery of revenues adequate to cover a "cost of service" which, the Commission said, substantially exceeds the actual cost of the gas subject to the order.

The court below read *Hope* [(*Federal Power Comm'n v. Hope Nat. Gas Co.*, 320 U.S. 591 (1943)] as in effect requiring the Commission to find the cost of gas sold by producers as a group and provide rates to cover such costs. The conclusion of the Commission based on sub-

stantial evidence that its rates were above such costs was held to be insufficient. In so holding the court below overlooked the rule laid down long ago by this Court, that on judicial review appellate courts could not upset the rate order unless confiscation is clearly shown. [*Los Angeles G & E Co. v. Railroad Comm'n,* 289 U.S. 287 (1932); *Lindheimer v. Illinois Bell,* 292 U.S. 151 (1933).]

The court below also overlooked the very words of *Hope* itself that

> " . . . the Commission's order does not become suspect by reason of the fact that it is challenged. It is the product of expert judgment which carries a presumption of validity. And he who would upset the rate order under the Act carries the heavy burden of making a convincing showing that it is invalid because it is unjust and unreasonable in its consequences." 320 U.S. at 602 (citations omitted)

This principle was reapproved by this Court in *Second Phillips, supra,* which involved the precise subject here at issue — ratemaking on an area basis. 373 U.S. at 309.

There was no showing that the rate order was confiscatory, there was no showing that the rate order was unjust and unreasonable in its consequences, and the Commission found precisely to the contrary on substantial record evidence.

It is our view that the Commission satisfied the *Hope* "end result" test; and indeed it is more than apparent that this was its goal in Opinion 468.

(b) The Court of Appeals' Decision is Incompatible With This Court's Pronouncements in the *Sierra* and *Mobile* Cases.

The Court of Appeals' decision is in clear conflict with this Court's decisions in *Sierra*[8] and *Mobile*.[9] The Court of Appeals implies that in testing to determine whether the revenue requirement of the industry is being satisfied so as to meet the *Hope* test, the Commission must take into consideration and compensate for revenue deficiencies caused by contractual price restrictions the producers have contractually bound themselves to.

This Court, in *Sierra*, held that contractual obligations cannot be upset by a regulatory agency unless there is a finding that the public interest requires it. The Commission can increase the contract rate only when it is so low as to adversely affect the public interest.

> "In such circumstances the sole concern of the Commission would seem to be whether the rate is so low as to adversely affect the public interest — as where it might impair the financial ability of the public utility to continue its service, cast upon other consumers an excessive burden, or be unduly discriminatory." 350 U.S. at 355.

The Commission's Opinion No. 468 found that the public interest did require a floor or minimum rate. It set this rate at 9 cents per Mcf. It did not find that the public interest required that the area rate be raised to

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[8] Federal Power Com. v. Sierra Pacific, *supra.*

[9] United Gas Pipeline Co. v. Mobile Gas Corp., *supra.*

compensate for low contractual commitments, nor did it find that rates in excess of 9 cents, but below the area ceiling, should be raised to the area ceiling to insure that revenues will balance costs. For the Commission to have done so would have been error, for there is no evidence in the record to sustain such a result. Nevertheless, the Court of Appeals implies that low rates must be raised to the area rate without the requisite finding that the contract rate is so low as to affect the public interest. This, we submit, misreads *Sierra* and *Mobile*. The Court of Appeals' holding should not be permitted to stand.

(c) The Court of Appeals' Suggestion Regarding the Savings Clause is Premature and Would Create Administrative Havoc.

Another error is the Court of Appeals' position on the savings clause — that clause which the Commission inserted in its decision to allow special relief when the public interest or constitutional considerations so required. The Court of Appeals found the Commission's provision "vague and nebulous." It said:

> "An adequate savings clause should contain guidelines which if followed by an aggrieved producer will permit it to be heard promptly and to have a stay of the general rate order until its claim for exemption is decided."[10]

It would be highly inappropriate to remand this important case for the purpose of establishing administrative procedures for savings clause relief. The lower court's

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[10] Appendix B, page 419.

concern regarding the detailed operation of the savings clause is premature. The appropriate time for judicial review of administrative procedures involving the savings clause would arise at such time as a producer seeks savings clause relief and is denied such relief as a result of procedural or substantive error on the part of the Commission. Further, the blanket mandatory "stay of the general order" suggested by the Court is judicially unique — traditionally, stays have been granted on the basis of the particular circumstances of each case. Adoption of the lower court's stay requirement would lead to administrative chaos completely frustrating effective area rate making.

CONCLUSION

"[T]o afford consumers a complete, permanent and effective kind of protection from excessive rates and charges,"[11] which Congress promised and this Court affirmed, immediate action is needed by this Court. This petition for a writ of certiorari must be granted this term so that further delays — which are in our view harmful to the entire gas industry — will be prevented.

Respectfully presented,

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[11] Atlantic Ref. Co. v. Public Serv. Com., *supra*, 360 U.S. at 388.

APPENDIX

TO

PETITION FOR A WRIT OF CERTIORARI

FILED
APR 19 1967
DAVIS, CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1966

No. ~~1294~~ [redacted] 102

PACIFIC GAS AND ELECTRIC COMPANY,
PACIFIC LIGHTING SERVICE AND SUPPLY COMPANY,
SAN DIEGO GAS & ELECTRIC COMPANY,
SOUTHERN CALIFORNIA GAS COMPANY and
SOUTHERN COUNTIES GAS COMPANY OF CALIFORNIA,

Petitioners,

vs.

SKELLY OIL COMPANY, et al.,

Respondents.

APPENDICES TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

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APPENDIX A

277,567

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Before Commissioners:

Joseph C. Swidler, Chairman; Lawrence J. O'Connor, Jr.; Charles R. Ross; David S. Black; and Carl E. Bagge

	Docket Nos.
Area Rate Proceeding	AR61-1
Claude E. Aikman, *et al.*	G-18466, *et al.*
North Central Oil Corporation (Operator), *et al.*	C160-435, *et al.*

OPINION NO. 468

OPINION AND ORDER DETERMINING JUST AND REASONABLE RATES FOR NATURAL GAS PRODUCERS IN THE PERMIAN BASIN

(Issued August 5, 1965)

INTRODUCTION

SWIDLER, Chairman:

This is the first area proceeding to determine just and reasonable rates for natural gas producers. It is the culmination of an effort initiated more than four and a half years ago, and which has been carried forward with the greatest sense of urgency on the part of all concerned. The area is the Permian Basin, one of the nation's great oil and gas provinces, comprising the counties of Chaves, Eddy and Lea, New Mexico, and Texas Railroad Commission Districts No. 7-C and No. 8.

Pursuant to Section 5 of the Natural Gas Act we here establish the future rates for jurisdictional sales of gas by producers in the area.[1] Also consolidated in this area proceeding are a large number of increased rate filings suspended under Section 4 of the Act and a limited number of applications for certificates of public convenience and necessity pursuant to Section 7 which are disposed of in a separate order issued this date.

The Commission initiated the proceeding by order of December 23, 1960 (24 FPC 1121). Prehearing conferences were held in Midland, Texas, beginning March 6, 1961, and in Washington on April 27, 1961. Forty-seven petitions to intervene were granted. The number of parties in the proceeding total 384, including 336 gas producers who are respondents.

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[1] The respondents are listed in Appendix A to this opinion.

The Commission prescribed questionnaires for the major producer respondents to obtain information with respect to Permian Basin and nationwide cost and operating experience. 26 FPC 247, 514, 531 (1961). A special form was prescribed for the small producers. 27 FPC 20 (1962). (The dividing line between major and small producers was determined by the level of nationwide jurisdictional sales, 10 million Mcf in calendar year 1960). A significant early ruling in this proceeding was the Commission's order of May 14, 1962, holding that individual company cost-of-service evidence would not be received in evidence but that composite cost studies would be admissible. 27 FPC 943 (1962).

The hearings extended over a period of almost two years beginning on October 11, 1961, and closing on September 12, 1963. The examiner rendered his decision on September 17, 1964.

Fourteen individual and joint briefs on exceptions were filed on behalf of 111 respondents and numerous other interested persons, not parties, who joined with them. Most of the producers adopted the briefs on exceptions of Continental Oil Company (Major Producer Group).[2] Separate briefs were filed by the Com-

[2] Respondents filing independent or supplemental briefs on exceptions included Amerada Petroleum Corporation (Amerada); Humble Oil and Refining Company (Humble); Hunt Oil Company, *et al.* (Hunt); Perry R. Bass (Operator), *et al.* (Bass); Phillips Petroleum Company (Phillips); Placid Oil Company (Placid); Standard Oil Company of Texas, a Division of California Oil Company (Standard); Sun Oil Company (Sun); Superior Oil Company (Superior); and Warren Petroleum Corporation (Warren).

mission staff, by the numerous interveners and as *amici curiae* by several groups with a substantial interest in the general problem.[3]

Oral argument lasting three days was held beginning February 8, 1965, and the proceedings are now before us for decision.

SUMMARY OF EXAMINER'S DECISION

We acknowledge at the outset our indebtedness to Examiner Wenner for his penetrating analysis of the basic economics of the industry and his constructive proposals for a pricing system in harmony with the realities of the industry and the Commission's responsibilities under the Natural Gas Act. We must acknowledge also the helpful and constructive role of the parties to the proceeding. The cooperation of the respondents and the interveners with the Commission has been instrumental in achieving what the examiner has described as a breakthrough in reaching a workable method of producer regulation.

---

[3] Interveners filing briefs on exceptions included Northern Natural Gas Company (Northern); King-Stevenson Oil Company, Inc., *et al.* (Oklahoma Interveners); the State of California and the Public Utilities Commission of California (jointly referred to as Cal-PUC); a group of California distributors (California Distributors); the City and County of San Francisco (San Francisco); the City of San Diego (San Diego); the State of Texas jointly with Texas Independent Producers and Royalty Owners and West Central Texas Oil and Gas Association (Texas-TIPRO-WCTOGA); and the Independent Petroleum Association of America (IPAA). Briefs on exceptions as *amici curiae* were filed by Philadelphia Electric Company (Philadelphia); Associated Gas Distributors (AGD) (a group of approximately seventy major distributors) and the Oklahoma Independent Petroleum Association (OIPA).

The examiner's decision would establish ceiling prices to apply, with certain exceptions, to all the sales being considered in this proceeding. These proposed ceilings were, in the case of rate schedules filed with this Commission on or after December 23, 1960, 16.75 cents per Mfc for gas-well gas, 15 cents per Mcf for residue gas, and 11 cents per Mcf for oil-well gas. In the case of rate schedules filed before December 23, 1960, the proposed ceilings were 13.5 cents per Mcf for gas-well gas and residue gas and 10 cents per Mcf for casinghead gas. The presiding examiner found, however, that the rates of producer-respondents making jurisdictional sales of less than 10,000,000 Mcf annually were just and reasonable and did not apply the proposed ceilings to any such respondents. Operators of processing plants, even if selling less than 10,000,000 Mcf annually, would have their rates limited by the proposed ceilings.

In the case of Section 4(e) proceedings consolidated herein, the examiner would order certain refunds which were to be computed for separate years and categories of gas on the basis of whether the industry had realized more than the proper revenue as well as on the basis of the individual rates collected. Deficiences in one category would be used to offset excessive revenues in

other categories each year. The presiding examiner further stated that since the record does not contain information needed to determine the actual or proper revenue for years other than 1960, for such years the parties

within 90 days of the initial decision should submit draft orders with requests for information and with specific proposals regarding refunds.

The presiding examiner declared most favored-nation clauses and spiral escalation clauses in existing contracts to be inoperative and of no legal effect, and would allow no future change in rate resulting from any such clause to take effect. He fixed a minimum price of 9 cents per Mcf for residue and gas-well gas and 7 cents per Mcf for casinghead gas, and would allow rate increases to these levels to be filed with the consent of the buyer.

THE NATURAL GAS INDUSTRY AND ITS ACTIVITIES IN THE PERMIAN BASIN

The major known deposits of natural gas in the United States are located primarily in the States of Texas, Louisiana, Oklahoma, New Mexico, and Kansas. In addition, there are substantial reserves in the offshore area of Louisiana and Texas. More than 70 percent of all the natural gas produced for marketing in the United States is sold in interstate commerce subject to the jurisdiction of the Commission. The Permian Basin alone accounts for about 11 percent of all the gas moving into the interstate market.

Natural gas and crude oil are both hydrocarbons, and they are often found in common reservoirs. As a result gas and oil production are interrelated. Our responsibility is confined to regulating the sales of natural gas. In his opinion (p. 23) the examiner classified natural gas as "oil well gas" or "gas well gas", depending upon

the conditions of production. He used the term "residue gas" to describe oil-well gas or gas-well gas after it has been processed and the liquids removed.

277,571

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The natural gas industry is divided into three distinct segments. First there are the producers. Jurisdiction under the Natural Gas Act attaches when the gas is sold for resale in interstate commerce. The intermediate segment of the industry consists of the interstate pipeline companies which transmit the gas from the producing fields through large diameter pipelines as much as a thousand miles or more to centers of distribution throughout the nation. The third segment of the industry comprises the distributors of the gas in thousands of communities throughout the nation who are under state or local regulation exclusively, but who rely on this Commission to regulate the price at which they purchase gas at wholesale from the interstate pipelines. It should be noted that there is some overlapping in these categories. Some pipeline companies produce a share of their own natural gas and sell gas to other pipelines; other engage in distribution operations. Also, some producers perform gathering or transportation services and some distributors engage in production and transmission activities.

The Permian Basin is a major geological formation underlying much of western Texas and southeastern New Mexico. It is rich in oil and gas deposits, and is one of

the major hydrocarbon producing areas in the Western Hemisphere.

About two-thirds of the gas produced in the Permian Basin is oil-well gas, that is, gas produced in conjunction with oil. By contrast, oil-well gas represents only about one-third of the total gas production in the continental United States. Oil-well gas is limited as to the hours of availability in a month since it is governed by the allowable oil production, which is subject to state regulation. The gas must be produced as the oil is produced, and it is not produced at any other time. It is produced on such a basis as will maximize the production of oil, for which it is the lifting agent. In

these respects it contrasts unfavorably with gas-well gas, which while subject to state prorationing authority on a field basis, can be produced on a demand schedule. Oil-well gas is also produced at lower pressures than those common to gas-well gas. Production at less than 50 pounds pressure is not unusual in the case of oil-well gas. Since pipelines require pressures approaching one thousand pounds, low-pressure gas must be compressed before it can be taken into a pipeline stream. Processing of such gas will include one, two, three or more stages of compression.

In the Permian Basin, most oil-well gas is "sour" gas before processing.[4] Some of the gas from the Permian Basin also has an unusually high carbon dioxide content, ranging in some instances as high as 50 percent. Carbon dioxide is non-flammable and is presently useless to the petrochemical industry. When present in significant quantities it must be removed, entailing both processing costs and reduction in the volume of gas which remains for use.

Historically, prices for gas in the Permian Basin have been lower than prices in most other areas. For many years oil-well gas was vented or flared, because there was no market for it. Three interstate pipelines, however, now make substantial purchases of gas in this area, and venting or flaring has been reduced to very low levels. El Paso Natural Gas Company (El Paso) began purchasing Permian Basin gas in 1945 for interstate transmission in connection with construction of the first natural gas pipeline from Texas to California. It was the sole interstate purchaser until 1954. In that year Northern Natural Gas Company (Northern) made its first purchase in the Permian Basin through Permian Basin Pipeline Company. In 1958 Transwestern Pipeline Company (Transwestern) began its purchases in the Permian Basin to supply the second pipeline from that area to California.

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[4] "Sour" gas is considered to be gas containing 10 or more grains of hydrogen sulphide or 200 or more grains of total sulphur per Mcf. The sulphur content of Permian Basin oil-well gas is generally higher than that of gas from any other area in the United States.

In 1961 El Paso purchased 73 percent of the Permian gas moving in interstate commerce; Northern accounted for 18 percent, and Transwestern for 9 percent. It is estimated that 85 percent of the gas moving in interstate commerce from the Permian Basin goes to California, an area of rapidly expanding demand by both industrial and residential consumers. The gas-producing wells in the Permian Basin, therefore, are some 900 to 1,300 miles from the principal points of use for the gas.

HISTORY OF THE DEVELOPMENT OF THE AREA APPROACH TO PRODUCER REGULATION

The Federal Power Commission's regulation of the rates of electric utilities and natural gas pipeline companies under the Federal Power Act and Natural Gas Act had uniformly been conducted on an individual cost-of-service basis at the time of the Supreme Court's *Phillips* decision on June 7, 1954[5] which held that the Commission had jurisdiction over the regulation of well-head gas prices, a jurisdiction the Commission had theretofore questioned. Faced with the novel problem of regulating thousands of gas producers, the Commission's first guarded attempts at producer regulation were on an individual company basis.[6] A few of the first rate in-

[5] *Phillips Petroleum Co.* v. *Wisconsin,* 347 U.S. 672 (1954).

[6] Ross, W. W., "The Area Rate Proceedings," 18 S. W. L. J. 165, 170 (1964); note, "F.P.C. Regulation of Independent Producers of Natural Gas," 75 Harv. L. Rev. 549 (1962).

crease filings were approved on the basis of cost evidence.[7] In other cases where the producer failed to submit evidence founded on the conventional rate base method of regulation, the Commission dismissed the rate increase[8] on the assumption that in the absence of such cost support it was bound to do so by *City of Detroit* v. *F.P.C.*, 230 F. 2d 810 (CADC, 1955), certiorari denied 352 U.S. 829 (1956), a case dealing with a pipeline's own gas production. On review of these rate increase dismissals the Court of Appeals for the Fifth Circuit

agreed that the evidence as to field prices coupled with opinion testimony as to the need for an incentive price to induce adequate exploratory and development activity was not enough to demonstrate the rates were just and reasonable but held the Commission should have given the producers further opportunity to present evidence. The Court also indicated that the Commission need not require conventional rate base evidence if other cost evidence was available to insure that consumers were not paying more than a just and reasonable price, and need not fix separate rates for each producer if it found a uniform rate for the field desirable.[9]

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[7] See *e.g., Davidor & Davidor,* 15 FPC 1236 (1956).

[8] See *e.g., Union Oil Co. of California,* 16 FPC 100, 110 (1956).

[9] *Bel Oil* v. *F.P.C.*, 225 F. 2d 548 (CA5, 1958), certiorari denied 358 U.S. 804 (1958); See also *Forest Oil Corp.* v. *F.P.C.*, 263 F.2d 622 (CA5, 1959).

The area concept also had its origin in proceedings under Section 7 of the Act upon applications for certificates of public convenience and necessity by gas producers. As early as November 28, 1955, in *Cities Service Gas Co., et al.*, 14 FPC 134 (1955), affirmed as *Signal Oil & Gas Co.*, v. *F.P.C.*, 238 F. 2d 771 (CA3, 1956), certiorari denied 353 U.S. 923 (1957), the Commission conditioned a producer certificate to the price level prevalent in the area (14 FPC at pp. 147-148). In some later cases the Commission failed to impose a condition on the initial price, the important example being the CATCO case,[10] relating to the offshore Louisiana area. As a result the Commission was reversed by the Supreme Court, which held that the Commission must impose a condition when the price was "out of line" in the area of production.[11] The area price concept was further developed in other cases remanding Commission orders granting unconditioned certificates.[12]

In the 1956-1959 period, a number of producer cases were initiated as investigations under Section 5(a) of the Gas Act. The first major case to reach the Commission

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[10] *Continental Oil Co., et al,* 17 FPC 880 (1957).

[11] *Atlantic Refining Co.* v. *P.S.C. of New York,* 360 U.S. 378, 391 (1959).

[12] See for example *United Gas Improvement Co.* v. *F.P.C.*, 283 F.2d 817 (CA9, 1960), certiorari denied 365 U.S. 881 (1961).

on the merits was the original *Phillips* case,[13] on remand from the Supreme Court. The Permian case is a direct outgrowth of *Phillips*. In that case the Commission first considered the numerous questions relating to Phillips' cost-of-service, including the difficult allocation of costs between Phillips' oil production and its gas production. While utilizing individual company cost-of-service to pass upon a limited number of increased rate filings, the Commission concluded that such an approach was not appropriate for fixing just and reasonable producer rates for the future. Accordingly, the Commission refused to fix Phillips' rates for the future on this basis. The Commission spelled out in detail the many reasons why the individual company cost-of-service approach did not offer a reasonable basis for determining the just and reasonable prices for sales of gas by producers in interstate commerce. It also pointed out that the administrative burdens of literally thousands of separate proceedings in itself demonstrated the complete infeasibility of attempting to achieve effective regulation on an individual company basis.

On the same day, September 28, 1960, that it issued its *Phillips* opinion the Commission issued its Statement of General Policy No. 61-1 (24 FPC 818 (1960), initiating the area rate approach by establishing guideline ceiling prices for the various producing areas. Separate levels were listed by the Commission for the initial prices at which it would certificate new sales of

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[13] *Phillips Petroleum Co.*, 24 FPC 537 (1960).

gas and for accepting without suspension price increases under existing rate schedules.

The Commission in prescribing guideline prices attempted to take into account all of the relevant information available to the Commission at the time. These

guideline prices did not purport to be the just and reasonable rates, but rather the interim guides the Commission would follow in issuing certificates and in deciding whether to suspend rate increases until just and reasonable rates could be determined after hearing in area rate proceedings. As a result of the guidline price policy, in a practical sense the area rate approach has been in effect on an interim basis for the past 4 years.

On review, the *Phillips* opinion was affirmed by the Court of Appeals and by the Supreme Court.[14] The courts upheld the Commission in going forward with the area method of regulation. The Supreme Court said (p. 310):

> We respect the Commission's considered judgment, backed by sound and persuasive reasoning, that the individual company cost-of-service method is not a feasible or suitable one for regulating the rates of independent producers. We share the Com-

[14] *Wisconsin* v. *F.P.C.*, 303 F. 2d 380 (CADC, 1961) affirmed 373 U.S. 294 (1963).

mission's hopes that the area approach may prove to be the ultimate solution.

The Commission has proceeded with its program to implement the area rate approach. In addition to the present proceeding, AR61-1, for the Permian Basin, a proceeding was begun on May 10, 1961, to determine area rates for the Southern Louisiana area, AR61-2, 25 FPC 942 (1961), and on November 27, 1963, area rate proceedings were instituted for the Hugoton-Anadarko Area, AR64-1, and for the Texas Gulf Coast Area, AR64-2, 30 FPC 1354 (1963). These four proceedings, which are all under way, have as their purpose the fixing of just and reasonable rates for about 75 percent of the gas flowing in interstate commerce.

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LEGAL BASIS FOR AREA RATES

In the second *Phillips* case (*Wisconsin* v. *F.P.C.*, 373 U.S. 294 (1963)) the Supreme Court, in holding that the Commission had not abused its discretion by rejecting the individual company approach, stated (pp. 308-309):

> * * * If we believed that such a departure from present concepts had little, if any, chance of being sustained, we would be hard pressed to say that the Commission had not abused its discretion in terminating this §5(a) proceeding while undertaking the area experiment. For if area regulation were

almost sure to fail, and if the individual company cost-of-service method of determining the reasonableness of rates had been abandoned, then there would be virtually no foreseeable prospect of effective regulation.* * *

But to declare that a particular method of rate regulation is so sanctified as to make it highly unlikely that any other method could be sustained would be wholly out of keeping with this Court's consistent and clearly articulated approach to the question of the Commission's powers to regulate rates * * *

More specifically, the Court has never held that the individual company cost-of-service method is a *sine qua non* of natural gas regulation.

A number of producers contend nevertheless that we are pursuing an inherently illegal method of regulating the field price of natural gas. Sun, in particular, has been vigorous in asserting that the Natural Gas Act precludes us from fixing maximum area prices at a level lower than a producer could justify on an individual cost-of-service basis.

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Sections 4 and 5(a) of the Natural Gas Act provide the authority for regulating the rates of the producers upon which the area rate order is based, but the breadth of the statutory scheme is evidenced also by the other

provisions of the Act which confer broad regulatory authority over sales for resale by gas producers in interstate commerce. For example, Section 7 of the Act requires every producer to obtain a certificate of public convenience and necessity prior to commencing any interstate sale and also requires Commission approval before abandonment of any gas which has been dedicated to the interstate market. Section 16 of the Act empowers the Commission "to perform any and all acts and to prescribe, issue, make, amend and rescind such orders, rules and regulations as it may find necessary or appropriate to carry out the provisions of this Act."

This area rate proceeding includes numerous individual rate increase filings in the Permian Basin which have been suspended. The rates specified in the filings have been collected subject to refund under the provisions of Section 4 of the Act, requiring that all rates shall be "just and reasonable." The area rate order will also apply under Section 5(a) of the Act to those sales of the respondents in the Permian Basin which are not being collected subject to refund. Section 5(a) contains the statutory standard for fixing the future rates for the sales in the area since its provisions are also applicable to rates fixed under Section 4. Section 5(a) provides that:

> Whenever the Commission, after a hearing had upon its own motion or upon complaint of any State, municipality, State commission, or gas distributing company, shall find that any rate, charge, or classification demanded, observed, charged, or

collected by any natural-gas company in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and

reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order: PROVIDED, HOWEVER, That the Commission shall have no power to order any increase in any rate contained in the currently effective schedule of such natural-gas company on file with the Commission, unless such increase is in accordance with a new schedule filed by such natural-gas company; but the Commission may order a decrease where existing rates are unjust, unduly discriminatory, preferential, otherwise unlawful, or are not the lowest reasonable rates.

While Section 4 of the Act prescribes that "all rates and charges" by *any* natural gas company shall be "just and reasonable", there is nothing in the Act which states or suggests that the justness and reasonableness of a particular company's rates cannot be determined on a group or area basis, rather than in a separate proceeding for

each company. Operating under a statute with virtually the same rate-making provisions as the Natural Gas Act, the Secretary of Agriculture, with the approval of the United States Supreme Court, has long fixed maximum just and reasonable rates for all stockyard marketing agencies of a particular yard, based on stockyard-wide data, rather than individual rates based on the costs of individual agencies. See *Tagg Bros.* v. *United States,* 280 U.S. 420 (1930); *Acker* v. *United States,* 298 U.S. 426 (1936); *United States* v. *Corrick,* 298 U.S. 435 (1936). The Federal Communications Commission, also operating under similar statutory commands, has for a number of years fixed the maximum just and reasonable rates for the competing international telegraph common carriers on a "bell-wether" basis, refusing, in the interests of its statutory mandate of providing the public with "adequate facilities at reasonable charges" (47 U.S.C. 151), to fix the rates "so that all carriers engaged therein may earn a fair return on the fair value of their property devoted to that service or even make some profit on their operations." *Postal Telegraph-Cable Co., et al.,* 5 FCC 524, 527 (1938). See also *The Western Union Telegraph Co.,* 25 FCC 535, 577-580 (1958).

Another example is action fixing a uniform price for milk in a milkshed, a form of regulation which was upheld in the landmark case of *Nebbia* v. *New York,* 291 U.S. 502 (1934). See *United States* v. *Rock Royal Co-op.,*

307 U.S. 533 (1939) (upholding Federal milk marketing orders under the Agricultural Marketing Agreement Act of 1937, 50 Stat. 246); *Sunshine Anthracite Coal Co.* v. *Adkins,* 310 U.S. 381 (1940) (upholding Bituminous Coal Act of 1937, 49 Stat. 991, authorizing Bituminous Coal Commission to impose maximum and minimum prices on an area basis). For the regulation of railroad charges the Interstate Commerce Commission has employed territorial classifications and group rates. *New York* v. *United States,* 331 U.S. 284 (1947); see also *Ayrshire Collieries Corp.* v. *United States,* 335 U.S. 573 (1949).

It is thus well established that governmental price regulation of services and commodities can be lawfully exercised over industries providing commodities or services on a group or geographical area basis. Many different regulating authorities with jurisdiction over an entire industry or common group have been upheld in exercising their rate-making authority on a group basis rather than conducting separate proceedings for each individual company. Moreover, with special reference to rate regulation under the Natural Gas Act, the Supreme Court has long held that neither the Constitution (see *F.P.C.* v. *Natural Gas Pipeline Co.,* 315 U.S. 575, 586 (1942)) nor the Act itself imposes any special "formula by which the 'just and reasonable rate' is to be determined." *F.P.C.* v. *Hope Natural Gas Co.,* 320 U.S. 591, 600 (1944). See also *Colorado Interstate Gas Co.* v. *F.P.C.,* 324 U.S. 581 (1945).

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The argument to the contrary stems primarily from a brief dictum in *Bowles* v. *Willingham*, 321 U.S. 503 (1944) in which the Court, in the course of upholding the lawfulness of war-time rent control legislation authorizing the Price Administration to fix, without advance hearing, maximum rents that were "generally fair and

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equitable", referred to the then recent *Hope* case for the proposition that "under other price-fixing statutes such as the Natural Gas Act * * * Congress has provided for the fixing of rates which are just and reasonable in their application to particular persons or companies" (*id.* at 517). It is significant that this statement predates the first *Phillips* case and its determination of the existence of Commission authority over producer rates. At the time of the Court's statement in the *Bowles* case, the Commission had not yet undertaken a program for producer regulation and was, as it still is, regulating pipelines under individual company cost-of-service procedures. The Court's dictum contrasting group regulation under the rent control statute with the individual company regulation of pipelines cannot be interpreted to suggest that the latter would be the sole appropriate method of determining rates under the Act for producers whose business involves entirely different economic and administrative problems. On the contrary, the Court went on to state that "considerations of feasibility and practicality are certainly germane to the constitutional issue [of group

versus individual company pricing]" (*id.*), that *Hope* had indicated that "price control, the same as other forms of regulation, may reduce the value of the property regulated" (*id.*), and that though "high cost operators may be more seriously affected by price control than others * * * it has never been thought that price-fixing, otherwise valid, was improper because it was on a class rather than an individual basis" (*id.* at 518).

Both the constitutional and the statutory questions, in other words, are not to be decided abstractly, but rather in the light of the nature of the specific rate-making problem involved, and of what is required to achieve a sensible result. The necessity for accommodating the system of regulation to the circumstances of the industry being regulated was recognized by the Supreme Court in the *Nebbia* case, *supra,* in which it was held that due process under the Fifth and Fourteenth

Amendments demand only that government regulation "shall not be unreasonable, abritrary or capricious, and that the means selected shall have a real and substantial relation to the object sought to be attained" (P. 525). In the words of the Supreme Court in *Hope, supra,* at p. 602 "Under the statutory standard of 'just and reasonable' it is the result reached not the method employed which is controlling."

We believe the area approach should be adopted because it is well adapted to the economic facts of the

industry and the practical administrative problems of carrying out the primary purpose of the Act, which is to achieve effective price control. We remain of the view, originally set forth in our *Phillips* decision in 1960 (24 FPC at 547), that the area approach will enable us to carry out our ultimate objective of setting prices in all producing areas.

Basic to this determination is the fact that objective cost standards for fixing just and reasonable rates for producer sales can best be developed by examining overall producer experience. An individual producer may find only dry holes or marginal wells on his search for gas may result in finding a huge new gas field. A price fixed by his individual cost experience could thus either be too high for consumers in relation to other available supplies or too low to be fair to the producer, considering his risks. However, on a group basis, costs and rates can be developed which will be fair to all concerned. A uniform ceiling price for the area will provide a fair relationship between the aggregate price the consumer pays and the aggregate costs that the producers incur.

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A uniform area pricing system is adapted to the economics of the natural gas industry. The producer who finds large reserves will achieve greater profits than the producer whose exploration efforts result in dry holes or marginal wells. Likewise, the producer whose enterprise is conducted with efficiency and economy will make

more money than the producer who runs his business poorly. There is a strong incentive in area pricing to prudence and economy which does not exist in individual company cost-plus pricing in an industry where individual cost norms are difficult to determine and apply. True, individual returns will vary greatly, but this is as it should be, provided that profits in the aggregate are at a reasonable level.

The area regulatory pattern thus conforms to the characteristics of an industry which, as much as any, is one where there is scope for greater or lesser reward as dictated by the results of exploratory efforts. The area price will give producers the incentive they need to explore to meet the nation's increasing demand for natural gas and yet give consumers the protection which the Act intended.

An obvious advantage of the area rate approach which is of great importance is that it enables the Commission to determine in a single proceeding rates which would otherwise require hundreds of individual rate cases. It will thus eliminate the administrative bottleneck of company-by-company determinations. As we have noted, the four area proceedings now under way will complete the task for 75 percent of the gas flowing in interstate commerce in the entire nation.

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The individual company approach would also result in a wide variety of rates in a single field, and even for

the sales by co-owners from a single well, depending on their varying company-wide costs. Such a system would raise staggering burdens of administration. Administrative feasibility is a vital element in the effectiveness of any method of regulation and our experience dictates that it should be given great weight in assessing the validity of the area approach.

The cases do not support the producers' contention that a just and reasonable rate fixed on the basis of the overall costs and profits of the producers in the area would be constitutionally confiscatory as to any respondent who could support a higher price on an individual company cost-of-service basis. The Supreme Court in *Acker* v. *United States,* 298 U.S. 426 (1936) rejected the argument that the pricing orders of the Secretary of Agriculture, fixed on a group basis under the Packers and Stockyards Act, were confiscatory as to a particular market agency, concluding that "in ascertaining a reasonable unit cost as the basis of a uniform rate the Secretary was not bound to, and indeed he could not, adopt any one [market] agency's costs" (*id.* at 429) and that "regulation cannot be frustrated by a requirement that the rate be made to compensate extravagant or unnecessary costs" (*id.* at 431). See also *Tagg Bros.* v. *United States,* 29 F. 2d 750, affirmed *Tagg Bros. v. United States,* 280 U.S. 420 ("It is not incumbent upon the Secretary to fix the rates so high that all agencies in the business would make money whether they did a substantial business or not."); *Bowles* v. *Willingham, supra;* and *Aetna Insurance Co.* v. *Hyde,* 275 U.S. 440 (1928).

In the *Aetna* case rates of all the stock fire insurance companies doing business in Missouri had been reduced by the superintendent of insurance under a statute authorizing him to limit the rates charged so that the "aggregate collections" by all the companies would not exceed a reasonable rate. The superintendent reduced the rates uniformly and on appeal by the companies involved the Supreme Court concluded that the Fourteenth Amendment was not violated merely because the aggregate collections were not sufficient "to yield a reasonable profit or just compensation to all companies that happen to be engaged in the affected business." (p. 447)

Even in situations where it is appropriate to fix rates on an individual company basis, the courts have held that a company's rates may be fixed at a level below that which would be justified on a normal cost-of-service basis, where the low rates result from self-imposed contractual limitations. (See *F.P.C.* v. *Sierra Pacific Power Co.*, 350 U.S. 348 (1955)) In an analogous situation, it was early held that a turnpike was not entitled to higher tolls on the basis of cost-of-service evidence where the real problem was the low volume of traffic (Covington & Lexington Turnpike Road Company v. Sandford, 164 U.S. 518 (1896)).

These cases make clear that there is no constitutional infirmity in the statutory authority to fix just and reasonable rates on an area basis, and argue persuasively that

in group ratemaking individual costs cannot be controlling. To hold otherwise would convert a proceeding to control prices into one that merely established a minimum rate above which every producer would be free to justify an above-ceiling rate in an individual company determination. A procedure under which the area rate would become a floor rather than a celing would destroy the area rate concept as an effective means of regulation. Such an approach to our consumer protection responsibilities under the Natural Gas Act would be neither just nor reasonable.

While we will not permit a back-door approach to individual cost-of-service under the guise of avoiding confiscation, there may well be circumstances in which a producer would be entitled to relief from his obligation to continue to render service to the public at the area rate or to make refunds for past periods. Accordingly we shall provide an opportunity for producers to petition

for special relief from the area rate as set forth in detail at pages 104-107. We cannot here visualize all of the circumstances which may serve as the basis for such relief, and will provide adequate flexibility to consider claims to such entitlement, but it is obvious that more must be shown than that the individual producer's costs exceed composite costs.

We believe the record in this case, judged in light of our experience in administering the Natural Gas Act,

clearly supports the conclusion that the area approach offers a regulatory method which is best adapted to the discharge of our responsibilities for protecting natural gas consumers while providing the greatest incentive to producers to continue their search for needed additions to our gas supply.

CONTRACT PRICES AS A BASIS FOR REGULATION

In considering the appropriate guidelines for regulating producer rates on an area basis, we must dispose of one threshold argument. Certain of the producers contend that their contract prices should be approved as meeting statutory requirements because they have been reached as a result of what is termed effective competition. IPAA contends that the examiner erred in not adopting as the standard for determining area prices the "market value" as established by natural gas purchase contracts negotiated at arm's length. A number of other producers propose a slightly more sophisticated version of this argument under which the contract rates negotiated at arm's length would be allowed to govern as long as the ratio of proven reserves to production did not become inordinately high.

We recognize that the history of negotiated prices in the area is an important element to be considered in reaching our decision. However, the producers' contention that the Commission should simply validate their negotiated prices, if accepted, would amount to an abdication of our regulatory responsibility.

The essential difficulty with the contract price argument is that there is nothing in this record which would justify a conclusion that reliance on contract prices unrelated to cost will "afford consumers a complete, permanent and effective bond of protection from excessive

rates and charges", which is the purpose of the Act in prescribing that the rates and charges to consumers of natural gas should be just and reasonable. *Atlantic Refining Co.* v. *Public Service Commission of New York (CATCO)*, 360 U.S. 378, 388 (1959). See *Wisconsin* v. *Federal Power Commission*, 373 U.S. 294, 309-310 (1963). *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672, 685 (1954). There are admittedly many producers selling gas to the interstate pipelines both in the nation as a whole and the Permian Basin in particular, but nothing in this record suggests that any competition among them in making sales to the pipelines is in any way adequate to assure that the public will secure gas at just and reasonable prices in the absence of regulation.

The history of price negotiations in the Permian Basin area is relevant to this issue. When El Paso was granted a certificate to supply natural gas to the California market on May 31, 1946, 5 FPC 115 (1946), it had entered into contracts with Phillips, Gulf, Shell, and Warren for a supply of gas in the Permian Basin. El Paso was to pay to Phillips 3.5 cents per Mcf, Shell and Warren 3.0 cents,

and Gulf 4.0 cents. These prices were subject to escalation by one cent every few years and to spiral escalation clauses by which they would be adjusted upward if El Paso's resale rates increased at the California border. Later, the spiral escalation clauses were deleted and indefinite favored-nation escalation clauses were substituted, except in the case of Phillips.[15]

In 1953, the Commission certificated Permian Basin Pipeline Company (a subsidiary of Northern Natural, and since merged into it).[16] The initial price amounted to approximately ten cents per Mcf for pipeline quality gas and was subject to escalation of one cent every five years.

In 1959, Transwestern Pipeline Company, 22 FPC 391 (1959), obtained a certificate to build a new pipeline from the Panhandle-Hugoton area of Texas and Oklahoma and from the Permian Basin to California. For the producers supplying gas to the pipeline the Commission authorized 16-cent prices and one 18-cent price, but the contracts called for prices as high as 21.8 cents in the West Texas-Permian area and 23.0 cents in the Panhandle-Hugoton area.

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[15] A favored-nation clause in a contract generally provides that the contract price shall be increased to equal higher prices paid others in a given area. There are numerous variations of the basic concept. Spiral escalation clauses are also indefinite in amount and provide for increases in producer rates in proportion to increases in the rates of the pipelines that are purchasing the gas from the producer.

[16] *Permian Basin Pipeline Co.*, 12 FPC 85 (1953).

The escalation clauses in the contracts and the urgent pipeline requirements for large volume gas reserves contributed to a continuous rise in Permian Basin prices. As a result of these escalation clauses and the expanding need for gas the 2.8-cent per Mcf average price paid by El Paso in 1947, its first full year of purchases, increased to 9.0 cents in 1954, the year of the first *Phillips* case, and reached 13.8 cents per Mcf in 1960. In that year, El Paso renegotiated most of its Permian contracts to eliminate the indefinite price clauses but was required to agree to price increases. The new prices ranged from 13.5 cents per Mcf to 17 cents per Mcf for gas of high quality.

We do not suggest that this historical pricing pattern in and of itself demonstrates the invalidity of the contract prices now in effect in the Permian Basin. On the contrary, it is obvious that the extremely low prices prevalent during the earlier period of large oil-associated supply and small demand bear no relationship to the cost of exploring for and producing gas even in that period, to say nothing of the present. However, while the record indicates that the costs of the various producers in the field differ markedly, there is no evidence that any significant volumes of gas of similar quality have ever been offered for sale at prices which reflect these cost differences.

The pipelines are far from being in a bargaining position which would validate the theory that a market price

will necessarily be a just and reasonable price. On the contrary the entire history of pipeline purchasing activity, since the end of the El Paso monopoly in the Permian Basin, has been characterized by the overriding needs of the pipelines to contract for the large blocks of uncommitted reserves essential to maintain their competitive position in developing markets (see *United States* v. *El Paso Natural Gas Co.*, 376 U.S. 651 (1964) and their inability to accomplish this objective except at ever increasing prices. The abstention of the pipelines from these proceedings does not indicate that any significant change can be expected in the future. The fact that many pipelines are themselves producers with an interest in generally higher producer prices also cannot be overlooked.

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There is no basis for concluding that there would be any effective producer price competition even if the pipelines were in a position to encourage it actively. On the contrary, until action was taken by this Commission, the entire pattern of producer contracts in Permian was on a basis of favored-nation and spiral escalation contracts calculated to assure that all producers would be treated alike and receive the highest going price both at the time of the contract and in the future. Typically, where a large producer has been able to command a higher price for a big block of gas needed by a pipeline entering the market or preparing for a major expansion,

this has had the effect of raising the price to all other purchasers by all other sellers big and small, and regardless of their costs or profit ratios. Moreover it is obvious that a key factual question in determining whether there is effective competition is the amount of uncommitted reserves controlled by the large producers. The pattern of sales and annual deliveries in the Permian Basin strongly suggests that a limited number of producers control a large percentage of the gas reserves,[17] and it is significant that the producers in the exclusive possession of the facts have made no showing to rebut this conclusion.

In *United Gas Improvement Co.* v. *F.P.C.*, 290 F.2d 133, 135 (CA5, 1961), certiorari denied 368 U.S. 823 (1961), it was said that the supply of gas controlled by the producers is so restricted in relation to demand that they have economic power to bargain for prices that will be injurious to the public. The Court held that the Commission in exercising its authority may not act merely upon proof that the prices in question were arrived at as a result of arm's-length negotiation, but must look behind the negotiated price. See also *P.S.C. of New York* v. *F.P.C.*, 287 F.2d 146 (CADC, 1961), *United Gas Improvement Co.* v. *F.P.C.*, 287 F.2d 159 (CA10, 1960). In so holding the court was reiterating the position it had taken in a series of cases involving just and reasonable

[17] The record reveals that 5 producers account for about one-half of the jurisdictional sales in the Permian Basin and 15 producers make about three-fourths of all the sales of gas in the area.

rates for independent producers under Section 4 of the Act in which it had concluded that:

> * * * evidence of unregulated prices in the field is not sufficient to warrant a finding by the Commission that a price comparable to them is just and reasonable within the

> intendment of the Natural Gas Act. Neither is evidence of the field price when coupled with the opinion of experts that the price must be high enough to provide an incentive for exploration and development of new sources of supply."[18]

If there is a case to be made for effective competition among producers in establishing just and reasonable rates it has not been made on this record. There is no evidence of competition between producers to make new sales by offering lower prices. On the contrary, the primary competition revealed by the record was among the pipelines to secure new gas supplies at higher prices. Whatever the

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[18] *Bel Oil Corp.* v. *F.P.C.*, 255 F. 2d 548, 553 (CA5, 1958) certiorari denied, 358 U.S. 804. See *Forest Oil Corp.* v. *F.P.C.*, 263 F. 2d 622 (CA5, 1959); cf. *City of Detroit, supra.* As the court indicated in the *Bel Oil* case the expert testimony purported to show that petitioners "did not possess any dominating position in the industry, that natural gas is competitive with other non-regulated fuels, that the proposed prices were comparable with unregulated prices for local consumption; that maintenance of such a price is necessary to provide appropriate incentives for exploration and production of natural gas in Louisiana." (p. 551)

degree of competition which may exist among producers it has not been effective to afford gas consumers the protection to which they are entitled under the Natural Gas Act. Under these circumstances, there is no basis for assuming that prices which "have leaped from one plateau to the higher levels of another" will constitute a level which will be "the lowest possible reasonable rate consistent with the maintenance of adequate service in the public interest." *Catco, supra,* at pages 391, 388.[19]

It is thus clear that our examination of the contract prices of the gas producers is only the beginning and not the end of our task in establishing the proper criteria for determining just and reasonable rates.

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RESERVES TO PRODUCTION RATIO AS A REGULATORY STANDARD

The producers contend that the gas supply situation is so critical that any significant limitation on contract prices would necessarily result in a dampening of essential exploration and development activity. In major part this argument resolves around the controversy as to the declining reserves to production ratio (R/P ratio) in the gas industry. This ratio has been as high as 32.5 to 1 in

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[19] As the Supreme Court pointed out in the *Catco* case, *supra* (at p. 388, footnote 7), this "declaration of which stems from the original version of Section 7 of the Act, was not intended to be changed by the 1942 amendment to the Act, which omitted that provision.

1946 and it has steadily declined to about 18,7 to 1 in 1963, based upon the reserve figures provided by the American Gas Association and the American Petroleum Institute.[20]

The producers suggest that the reserves to production ratio should be the barometer by which the Commission is guided in setting any limitations upon the producers' contract prices and specifically that no such limitation should be imposed if the R/P ratio is not at least 20 to 1. Alternatively, they argue that, even if the Commission were to adopt the 17.5 to 1 ratio which the examiner believed was a reasonable target for 1970, present trends indicate that a lower ratio will be reached by that date; and they argue further that fixing area ceilings below existing contract prices would act as a brake on producer investment in gas exploration and development, and would therefore be contrary to the public interest.

In evaluating the producers' argument we must first analyze the forces which have determined the overall level of exploration and development by producers in the Permian basin and elsewhere. The overwhelming fact which emerges from this record is that the vast increase in exploration and development of gas supplies which has taken place in the last two decades has resulted from the development of a system of interstate pipelines which has created an ever increasing nationwide market for gas. In short, the producers have stepped up their

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[20] The 1964 statistics available after the record was closed revise the R/P ratio for 1963 to 19.0 to 1 and reveal that the ratio in 1964 was 18.3 to 1.

exploration and development activity because a market had been created for their product, even though during most of this period the prices have been far lower than fully allocated costs as determined herein.

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We agree with the examiner that the emergence of directionality, *i.e.*, the ability of producers to direct their drilling activities toward either oil or gas, brings into being for the first time an opportunity for price to play a significant role in increasing the supply of gas-well gas available to the interstate market. We have reflected this fact in the system of ceiling prices which we are adopting because, in our opinion, the true benefits of directionality can be best achieved through a two-price system which, though based on costs, by its very nature provides a special inducement for exploration for gas-well gas. Such a system should permit price to play its full role in eliciting needed gas supplies. To permit still higher prices would only create windfalls for the producers with no assurance of any concomitant consumer benefits.

We agree that a strong exploration program which will discover and develop gas reserves in ample time to meet the increasing demands of gas is vital. Any method of fixing just and reasonable prices must take this into account. However, there is no reason to assume that there is a direct relationship between any calculated R/P ratio and the price of gas. On the contrary, the R/P ratio went steadily down during the periods in

which gas prices were staging their most spectacular increases. It seems clear that even an exploratory program which will continue to add substantially more reserves annually than are produced is almost certain to fall short of preventing a further decline in R/P ratios.

As long ago as 1957, the AGA in *Gas Facts,* 1957 edition, page 6, stated that the industry should not be preoccupied with a "hypothetical" reserves to production ratio, but should focus its concern on finding sufficient gas to replace that consumed each year. There is considerable doubt that it is desirable, from the point of view of the public or the industry, to require or encourage a high level of proven reserves many years in advance of their probable use. It is an extremely costly matter to find and hold reserves beyond those which are needed to

assure ample supplies to consumers. The Commission's recent action in allowing exceptions to the 12-year minimum deliverability rule was a limited step in recognition of this fact.[21]

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[21] Order No. 279, 18 C.F.R. 2.61, 260.7; issued March 31, 1964, prescribing the filing of annual reports by pipelines to furnish information with respect to total gas supply and deliverability stated, "* * * information from the reports will make it possible to relax the Commission's 12-year deliverability life requirement where the information supplied by the pipeline company indicates it has an active procurement program, its system extends into production areas with continuous exploration and the results thereof indicate continuing ability to meet gas requirements."

There is also serious question as to the reliance to be placed on the available R/P ratio figures. The proven reserve figures are admittedly conservative. The amount of proven gas reserves added each year depends more upon revisions of former reserve estimates which have varied widely than upon new findings. The true ratio of reserves to production is undoubtedly higher at the present time than would appear from available statistics.

For all these reasons, we believe it would be doubtful wisdom for this Commission to attempt here to fix the minimum appropriate level of reserves for the industry, and particularly we think that it would be unwise as well as futile for us to attempt to gear our pricing policies towards maintaining a reserves to production ratio of 17.5 to 1 or higher. The ratio has already declined very close to that point, and it will probably decline further regardless of the price of gas set by this Commission. Such a decline is the inevitable result of increases in consumption on the scale that we have witnessed in the past decade. Under these circumstances, any attempt to maintain a specific ratio of reserves to production by permitting interstate prices to reach their maximum contract level would be much more likely to affect adversely the market for gas than to induce substantially greater supplies.

The impracticability for the long term of attempting to maintain indefinitely a 17.5 to 1 ratio may be demonstrated by some simple figures. It is estimated that by 1980 natural gas use, already more than 15 trillion cubic feet a year, will have grown to 25 or more trillion and by

the year 2,000 annual use can be expected to exceed 30 trillion. This level of use at the specified ratio would require reserves of 525 trillion cubic feet. By that date we shall have used some 900 trillion cubic feet of gas now in the ground, which would mean a total of some 1400 trillion cubic feet would have been found. This is in the middle of the range of responsible estimates of the total gas found and to be found in the United States.

That the reserves ratio will decline is not necessarily a cause for concern for many years to come. The high ratios of the past were not a result of design or of business prudence, but resulted rather from lack of a market for the immense reserves discovered in the search for oil. In such circumstances the imposing reserve ratios of the past have little significance. With the intensive post-war development of the natural gas market we are witnessing an adjustment of the reserve ratio to economic levels.

While the adequacy of reserves is an important factor in our determination here, and will continue to be an important factor in reviewing area rates in the future, we cannot accept the producers' position that the maintenance of a particular R/P ratio justifies the existing and future contract prices, whatever they may be.

THE TWO-PRICE SYSTEM

The presiding examiner at pages 12-38 of his opinion presents a persuasive discussion of the "Economic and

Institutional Factors Which Govern the Method of Establishing Area Rates."

The touchstone of the presiding examiner's decision is his conclusion that the industry is increasingly becoming able to direct its exploration efforts toward finding new gas-well gas as distinguished from finding gas as a by-product in the search for oil. This newly documented ability of the industry to channel its exploration investment toward either gas or oil serves as the basis for a pricing system, which we here adopt, that will make use of the economic drive of the industry in order to bring needed gas supplies to consumers at the lowest reasonable price.

The Commission's staff and some of the interveners argue that even if some companies can effectively direct their exploratory activities toward gas, it has not been shown that all of the Permian Basin producers can do so. In making this argument special reliance is placed upon testimony to the effect that small producers do not have the resources necessary for effective directional exploration.

We have considered the evidence presented and we conclude, as did the examiner, that the larger producers in the industry have shown an increasing ability to direct their drilling activities toward either gas or oil, as they desire. Large producers maintain geological staffs and extensive files of geological information upon which the

necessary predictions can be based. While small producers, may lack the capital to maintain the organizations necessary for effective prediction, they often drill on lands obtained on farmouts from larger producers and thereby obtain the benefit of the geological knowledge required for directional drilling. To this extent it appears that even small producers are often able to drill with some assurance as to what they may expect to find.

In agreeing with the examiner's finding on directional drilling we do not mean to suggest that all exploration and development activity by producers is based upon reliable predictions as to what if anything will be found. What we do say is that on this record a major portion of the industry operating in the Permian Basin in recent years has demonstrated the ability by directional drilling to increase the known supply of gas, provided that the regulated price and the demand for gas justifies such an investment. Looking to the future we are establishing a pricing system that will encourage the industry to expand and perfect its ability to drill directionally so that revenues from gas consumers can increasingly be devoted to finding additional gas reserves.

In referring to the incentive provided by the ceiling for "new" gas-well gas we are not providing any special, isolated amount as a separately designated incentive. The inducement to be found in the "new" gas price is of an inherent nature and is not represented by any sum ear-marked for that purpose. The incentive is built into the two-price system. It provides a price for the future related to current and future costs and payable only to

producers who discover gas-well gas and dedicate their discoveries to the interstate market.

A single price based on an average of historical and current costs could not provide the same incentive to explore for gas in the future even if it yielded the same

revenue. A single price based on future costs will result in windfalls to those producers who acquired and sold gas under lower cost conditions. The two-price system thus holds out a reward to encourage producers to engage in further exploration and development while preventing excess and unnecessary revenues from the sale of gas developed at a period when there was no special exploratory activity directed to gas discovery.

The producers favor a single price and the arguments they make are aimed at obtaining the "new" gas price as the one price to be applied to all gas. We disagree. If a one-price system were to be adopted, average historical costs — not the higher current costs — would necessarily serve as its foundation, and we have no assurance that such a price would elicit the investments at current cost levels which are needed to bring forth adequate new supplies of gas-well gas.

The producers support a contention for a single price based on current costs with the argument that current revenues provide financial support for current exploration and development. Assuming *arguendo* the factual

basis for the argument, this is not an acceptable reason for "flowing gas"[22] being the beneficiary of "new" gas-well gas prices. The producers' inducement to engage in further exploration and development directed toward gas comes from the knowledge that future gas supplies will receive a price which provides adequate compensation. Of course the availability of funds to seek new sources of supply is a factor to be considered in the fixing of all prices, and we have not overlooked this factor in the determination of the "flowing" gas price. It does not follow that a single price for all gas is required. On the contrary, as already stated, if such a ceiling were fixed high enough to elicit new gas-well gas supplies it would result in windfall profits for all other gas and if fixed low enough to reflect costs for old gas it would not assure adequate supplies for the future.

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The record in this case was augmented by the econometric studies introduced by the staff and a rebuttal showing by the producers. These studies are, as the examiner stated, truly pioneering endeavors. The studies were not designed to support a specific rate recommendation or rate design but served to focus attention upon the important role of market demand among the considerations relevant to our decisions. The studies indicate that ad-

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[22] The term "flowing gas" in this opinion will be used to include old gas-well gas, oil-well gas and residue gas as explained in detail at pages 78-80, *infra*.

vanced statistical and mathematical techniques can be useful in understanding the interaction of the price of gas at the wellhead and the demand in the marketplace.

The econometric studies in this case were based on the assumption of a one-price system and as noted by the examiner, "on a non-directional hypothesis." The quantitative results of the studies therefore cannot be relied upon in this case although the studies tend to support our conclusion that a two-price system is necessary and desirable to make positive use of the interaction of price and gas supply.

It has been suggested that providing a separate ceiling for new gas-well gas may retard the search for gas by inhibiting demand, on the theory that high prices may price gas out of some markets. This argument may have some merit as an abstract proposition but it misses the mark when applied to the facts of this case. We are not here fixing a ceiling that will increase prices but rather one to reduce unreasonably high prices and stabilize field prices generally. Furthermore while fixing a higher ceiling for new gas-well gas (including residue gas derived therefrom) we are also fixing a lower ceiling for all other gas. Certainly the ceiling prices fixed herein which will stabilize gas prices that have been increasing in the past cannot be a basis for predicting a declining market.

Some who opposed the examiner's price strúcture also argue that no need to encourage a stepped-up search for additional reserves at this time has been shown. It is pointed out that on a nationwide basis the AGA figures on proven reserves show that more gas has been found each

year than was consumed, even though the reserve ratio as computed by AGA has been declining. It is also argued that we must take into account increasing discoveries of gas in Canada and Mexico as well as the possibility that technology may make new sources of energy available to supplement gas long before present reserves are exhausted.

It is beyond dispute that continuing exploration and development of new gas reserves is necessary in the public interest. The only question is the proper scale of the necessary effort. In the absence of a regulatory pattern which offers encouragement for the search for gas there is no guarantee that the present generally satisfactory pace of exploration will continue, much less increase to meet growing demands. New gas discoveries are the lifeblood of the industry and are also essential to consumers who are tied to natural gas. This Commission cannot discharge its responsibilities to the public by relying on unsupported suggestions that gas supplies from distant sources or other forms of energy will suffice to meet an obvious need for new gas supplies to serve the needs of the pipelines and of their consumers who are tied to the use of this fuel by large investments in gas utilization equipment.

In the past the greater part of the gas in the Permian Basin was found in the course of searching for oil but, as the examiner found, in recent years there has been a decline in drilling for oil. The future needs of the gas

market can no longer be satisfied by the incidental discoveries in the search for oil. Accordingly, there will be a greater dependence on exploring for gas wells to bring forth needed gas supplies in the future and this fact supports our conclusion to fix a higher ceiling for new gas-well gas which will encourage exploration at deeper horizons directed toward finding gas.

The separate price we fix herein for new gas-well gas in the Permian Basin should serve to furnish a practical test of whether in fact it will result in bringing forth additional supplies. In order to assure that every effort

will be made by producers to bring in new gas-well gas we also state our conviction that the ceiling set in this proceeding should continue to apply to all such new gas dedicated within the ceiling fixed herein even if in any later review of the area rate for the Permian Basin the evidence indicates that a lower price would be justified for future discoveries. We cannot bind the Commission for the future, but we state our view that any lower ceiling should apply only to new gas dedicated after the ceiling price may have been subsequently reduced.

On the basis of the record made in this proceeding and after careful consideration of the arguments against the examiner's findings on these points we conclude that there is substantial support for pricing new gas-well gas at a higher level in order to encourage the search for new gas reserves at minimum overall cost to consumers.

THE DATE OF DIVISION BETWEEN NEW GAS-WELL GAS AND OLD GAS-WELL GAS

The presiding examiner fixed December 23, 1960, the date this proceeding was initiated, as the date dividing new gas-well gas from old gas-well gas. Gas moving under contracts filed with the Commission before December 23, 1960, would be classified as old gas; gas moving under contracts filed on or after that date would be new gas. Staff has advocated a division date of January 1, 1961, which would offer the administrative convenience of making the division at the beginning of the calendar year. The California Distributors urge that the new gas price should be effective only as to gas moving under contracts filed after the conclusion of this proceeding. They argue that any incentive element included in a higher price for new gas can fulfill its purpose only with respect to gas dedicated to interstate commerce after the conclusion of this proceeding. The Major Producer Group, on the other hand, would apply the new gas price to all gas moving under contracts dated after June 7, 1954, the date when regulation of natural gas producers commenced.

The argument that a two-price system should have a 1954 breaking date is weak. The essential justification for the dual price system is that with the recent development of directionality there is for the first time a basis for believing that gas exploration and development activi-

ties may be responsive to price. To apply a price based upon the present cost of finding and developing gas-well gas to such gas (to say nothing of casinghead and residue gas derived therefrom) developed before the era of directionality would be inconsistent with the rationale of our decision and bestow a windfall on the producers.

There is more plausibility to intervener's argument that the cut-off date between new gas and old gas should be the effective date of this decision. We agree with the examiner, however, that the proper breaking point should be at or near the end of 1960. As indicated *infra*, our price for flowing gas including old gas-well gas is being fixed primarily on the historical cost-of-service for this case as derived from the respondents' cost data supplied in response to the Commission inquiry. The test year for such data is 1960. Moreover, while the new gas-well gas ceiling is based on current rather than historical costs, the record indicates that directionality upon which the two-price system is based first became significant about 1960, and that costs have remained constant since that time.

There is another reason why we believe that a date approximating that fixed by the examiner is in the public interest. In effect, the two-price system which we have now prescribed was established for Permian and many other pricing areas in the adoption of our dual guideline ceilings by the September 28, 1960, Statement of Policy. Our pricing policy has given different treatment to gas dedicated since that date than to older gas. The expectations of producers which would presumably result from

this policy of the Commission are thus consistent with the cost of considerations referred to above.

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The specific date for distinguishing between old and new gas-well gas presents, we believe, primarily an administrative problem. The examiner suggested December 23, 1960, the date of the institution of the Permian proceeding, but this would imply that the old gas/new gas breaking point in the various areas should depend upon when the particular area case was initiated — a date which has no necessary relationship to any of the considerations referred to above. It has been suggested that the September 28, 1960, date on which we issued the Phillips decision and the statement of policy should be utilized. However, our decision therein could hardly have had any such instant effect upon contract negotiations, to say, nothing of the effect upon exploratory activity. Moreover, using September 28, 1960, as the dividing point would mean that some of the gas sold in the test year and used for determining old gas mixes would receive new gas treatment. We think that, all things considered, it would make more sense to set the dividing line as of the end of the 1960 test year. Accordingly, the new gas ceiling will be made effective for contracts entered into on or after January 1, 1961.

BASIC STANDARD FOR NEW GAS-WELL GAS CEILING PRICE

It becomes necessary at this point to define gas-well gas with more particularity. By gas-well gas we mean so-called nonassociated gas, that is, gas from dry gas reservoirs and gas condensate reservoirs, and gas from gas-cap wells.[23] Within these definitions the classification of gas wells by the appropriate state agency will be accepted for purposes of this decision in the absence of a showing that it is not a reasonable classification for pricing purposes. The definition of all other gas will be discussed *infra* at pages 70 and 75.

Except for those parties who advocate existing contract prices as the primary regulatory standard, all parties recognize that costs must be a major factor in determining the area price. If the area rate approach is to rest on a solid foundation there must be an objective test by which the industry, the consumers and the courts can appraise the fairness of the price we fix. We are convinced that a composite cost determination is the bedrock on which a regulated price must be established. The issue

[23] Gas-cap gas is a special category of gas from an oil reservoir that can be produced free from the influence of oil production. As a practical matter state classification of the small amount of gas in this category in the Permian Basin makes it reasonable to include gas-cap gas in the category of gas-well gas. If production of gas-cap is governed by allowables set for oil by the state agency, it will not be considered gas-well gas.

is thus narrowed to one of the weight to be given cost evidence and the particular cost-finding technique we are here to adopt.

The Supreme Court in the second *Phillips* case, in upholding the Commission's abandonment of individual company cost-of-service and sanctioning the Commission's efforts to proceed with the area rate approach, observed with approval that the Commission had stated that area rates would be based on the "'reasonable financial requirements of the industry' in each production area" and that "composite cost of service data will be considered in the area rate proceedings." (376 U.S. at 310)

Accordingly, we conclude that composite cost showing must be the basic ingredient in determining the area rate. This does not mean that other factors should not be considered. The Commission must exercise its judgment and determine a rate in light of all the evidence in the record. For one thing, the rate must be one that the evidence indicates will elicit a level of exploration activity adequate to provide the increased gas supplies required by consumers in the future. There is also a need to exercise judgment in the design of the rates to avoid unnecessarily sharp and abrupt departures from existing pricing patterns and the business and community dislocations which could result. Of course, in fixing the rate of return, a key element in the cost of determination, the Commission has wide discretion to consider these factors, so that to a considerable degree they can be accommodated within the framework of composite cost pricing. Nevertheless,

we make clear that we do not confine ourselves to a cost calculation in determining just and reasonable rates.

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Basic to our determination of the guidelines for the price of new gas-well gas is the selection of the method of cost finding to be adopted. We shall discuss later in this opinion the cost basis for all other gas but it may be helpful here to say that we shall use the cost of gas-well gas as the yardstick for all prices we fix in this proceeding. We do so for two reasons. First, the record reveals that casinghead gas and other associated gas are found largely as a by-product of the search for oil. Historically, casinghead gas has not been priced on a cost basis and any cost-finding technique is unrealistic which assigns large sums for exploration and development to casinghead gas. A second and related reason is that gas-well gas costs are much more meaningful because they are far less dependent upon allocations between gas and oil than are the costs of casinghead and other associated gas.

The parties suggested three basically different methods for determining the cost of new gas-well gas. The main producer presentation is an estimate of the cost of financing new supplies of gas-well gas on an industry basis in which all exploration and development (E&D) expenses are capitalized and a discount rate of return utilized. The California Distributors also presented a gas-well gas cost study based on published national statistics and the answers by respondent producers to

the Commission's cost questionnaire but instead of capitalizing E&D cost, expensed them, and utilized a conventional rate of return. Both methods provide a nationwide cost for gas-well gas keyed to the cost of finding and producing new gas supplies. The third cost approach, presented by the Commission's staff, is a composite presentation patterned after the individual company cost-of-service approach in which there is determined the historical cost per Mcf of gas-well gas production. The staff also presented a similar composite presentation limited to Permian Basin area costs.

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A preliminary question in determining the methodology of cost finding is whether costs are to be determined on an area or a national basis. As the examiner pointed out, the question is not whether a national price should be established but whether national or area costs should be used as the basic standard for fixing the future price of new gas-well gas in the Permian Basin. All parties agree that exploration and development operations are conducted by the industry on a national basis because it is impossible to isolate E&D by areas. Without adopting all of the reasons advanced by the examiner at pages 40 and 41 of his opinion we agree with the conclusion that the cost of new gas-well gas should be determined on a national basis. Perhaps most persuasive is the fact that we are fixing a price based upon current cost of finding an Mcf of gas and that much, if not most, of the rele-

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vant information is available only on a national basis. It may be that in some areas production costs may vary sufficiently from the national average to warrant a different treatment but on the record in this case we agree that cost of new gas-well gas should be determined on the basis of nationwide data.

The examiner adopted, with modifications, the cost presentation of the California Distributors. We agree with the examiner that in determining a ceiling for new gas-well gas which is to serve as an incentive to search for additional gas the preferable approach is the one that is geared to the recent cost of finding and producing an Mcf of gas rather than the historical cost based on production volumes. Historical costs will not necessarily reflect current realities.

A price based on the current cost of finding and producing an Mcf of gas-well gas, on the other hand, should provide the economic incentives to find and sell gas under prevailing conditions at rates which are keyed to industry needs and at the same time protect the interest of consumers.

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We believe that the method of costing we have adopted in this proceeding is required on the basis of the record before use and that it provides a sound basis for our decision. We emphasize, however, that our conclusions herein should not be construed as necessarily constituting the final solution of this intricate problem. Other methods

of estimating the new gas cost may be given further consideration in succeeding cases if adequately supported.

THE COST OF NEW GAS-WELL GAS

We shall now proceed with an examination of the presiding examiner's determination of the cost of new gas, and of the exceptions thereto, in our determination of the area price ceiling of new gas-well gas.

A word of explanation is in order as to the variety of data sources utilized for determining the cost of gas in this proceeding. The natural gas producers, unlike electric power companies and natural gas pipelines, have not as yet been required to conform their books to a uniform system of accounts. The petroleum producers typically do not reveal their cost experience or accounting treatment in depth. When this proceeding was initiated there were no statistics available based on a uniform set of accounts to provide the necessary information for making the cost determinations in this proceeding. The cost questionnaire promulgated by the Commission was designed to fill this information gap in part and the responses have supplied a vital source of information for determining costs in this proceeding. In addition Census data and other well-recognized and authoritative industry data sources were utilized by various witnesses in the proceeding. The record is thus built upon a variety of sources which we believe in combination provide an adequate basis for the costs we have found.

The presiding examiner found that the national average cost of an Mcf of new gas-well gas was 16.88 cents. His

computation and our modifications thereof may be summarized as follows:

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	Cost in Cents per Mcf	
	Examiner	Commission
Exploration and Development Costs		
Dry Holes	1.42	1.42
Other Exploratory Costs	1.59	1.59
Adjustment for Exploration in Excess of Production	1.11	1.11
Production Operating Expense	2.88	2.70
Net Liquid Credit	(2.68)	(3.10)
Regulatory Expense	.14	.14
Depletion, Depreciation, and Amortization of Production Investment Costs		
Successful Well Costs	2.88	2.88
Lease Acquisition Costs	.76	.76
Cost of Other Production Facilities	.31	.31
Return on Production Investment (at 12 percent)	5.21	5.21
Return on Working Capital	.20	.35
Subtotal	13.82	13.37
Royalty at 12½ percent	2.11	2.05
Production Taxes[24]	.95	1.01
Total	16.88	16.43

[24] Texas production taxes of 7 percent have been used in the Commission's computation. New Mexico taxes are lower, and both cost computations and the ceiling price should be reduced accordingly for gas produced in New Mexico. The amount of production taxes does not include taxes on the royalty payments which are chargeable to the royalty owner.

EXPLORATION AND DEVELOPMENT COSTS

Dry Hole Costs

Adopting the California Distributors' presentation, the presiding examiner derived a dry hole cost of 1.42 cents per Mcf principally on the basis of data published by the United States Bureau of Census, Census of Mineral Industries for 1958 (1958 Census), with respect to drilling costs per foot. Since there were no such census costs available for 1960, he established a trend for such costs by comparing 1958 and 1960 cost data obtained, in response to the questionnaire circulated by this Commission, from producers of more than 10 million Mcf annually, producing in the Permian Basin.[25] He then adjusted the 1958 Census figures in accordance with the trend established from the questionnaire data to establish the 1960 costs.

The Major Producer Group objects to the examiner's use of questionnaire data to establish a trend in E&D cost from 1958 to 1960 and adjusting the 1958 Census figures on the basis of the trend established. We think the examiner was correct in determining that the questionnaire data are valid for purposes of establishing a trend in the entire industry. We adopt the reasoning of

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[25] The questionnaire data includes costs from a few producers of less than 10,000,000 Mcf annually who also responded to the questionnaire. However, the inclusion of this data does not affect the results.

the initial decision upon this point, and the 1.42 cents per Mcf cost, as set forth in Appendix B, pages 1 and 2.

As we have already noted, other methods of computing dry hole costs were suggested in the record. Of particular interest in the alternative method of cost determination, advocated by the Major Producer Group, often called the project method, which capitalizes the total cash outlays to acquire a capital asset (*i.e.*, project) and allows a return on that investment over its productive life. Under this method, dry hole costs and other costs associated with unproductive ventures would be capitalized along with the cost of productive ventures. We find that this alternative method which would constitute a departure from our treatment of E&D in prior proceedings as well as a deparure from present industry accounting practices is not adequately supported in the record. The inadequacy is especially

notable with respect to the cost of capital for establishing the fair rate of return to be allowed on the computed investment base. However, capitalization of E&D may well be a useful approach and we do not foreclose in succeeding cases further consideration of this alternative method of costing or of improvements in the cost-finding techniques herein employed.

Other Exploratory Costs

In a category for exploratory costs other than dry holes, the examiner included geological and geophysical

expenses, lease rentals, and exploratory overhead. These costs were the subject of testimony by Witness Roseman for the California Distributors and Witness Park for Texaco, Inc. Roseman estimated the cost of geological and geophysical expenses and lease rentals on the basis of their relationship to lease acquisition costs as shown by the Chase Manhattan Bank's Annual Analysis of the Petroleum Industry for 1961. Since the purpose and result of the outlays for geological and geophysical activities and lease rentals is the purchase of leases, there is a direct relationship involved. The Chase survey shows that geological and geophysical expenses and lease rentals average 138 percent of lease acquisition costs in the period 1957 through 1960, the same period Roseman used in computing lease acquisition costs. Having determined that the lease acquisition costs for that period were 0.76 cent per Mcf (see pp. 51-52), Roseman accordingly computed the geological, geophysical, and lease rental costs at 1.05 cents per Mcf.

Exploratory and developmental overhead were calculated by Roseman on the basis of their relationship to total finding and developmental costs. The 1958 Joint Association Survey, the only published source of such data, established overhead costs as being 8.4 percent of total finding and development costs, or 0.54 cent per Mcf. (Total finding and developmental costs were 6.42 cents per Mcf, this being the total of 1.05 cents for geological and geophysical expenses and lease rentals, 1.42 cents for dry holes, 2.88 cents for successful well costs, 0.76 cent for lease acquisition costs, and 0.31 cent for cost of

other production facilities.) Adding 0.54 to the 1.05 cents per Mcf costs for geological, geophysical, and lease rental costs, results in a total of 1.59 cents for the category of Other Exploratory Costs.

Witness Park used a different method. He combined geological and geophysical expenses, lease rentals, and overhead into a single item. He then found that the ratio of this item to dry hole exploratory expense, based on the Joint Association Survey, was 1 to 1. His result is 1.56 cents.

We believe that Witness Roseman's approach which computes each of these items of cost on the basis of comparisons with items to which they are functionally related is preferable. In any event the difference between the two witnesses is *de minimis* and no exceptions were taken to the examiner's determination of 1.59 cents per Mcf based upon Roseman's testimony. We therefore adopt the examiner's finding as supported in the accord.

ADJUSTMENT FOR EXPLORATION IN EXCESS OF CURRENT PRODUCTION

The record establishes that additions to proved reserves of natural gas in the United States have exceeded production in each year. We believe it essential to encourage a level of exploratory effort which will continue to provide for findings in excess of production. Since

exploration and development losses are expensed by the industry in the year incurred, and are so treated here (but see our discussion of the possible use in the future of the project method, pp. 41-42), the allowance for such losses should be recouped from production during that year. The total cost of finding the necessary volumes of gas must be translated into an allowance per Mcf of gas produced so as to bring in the necessary revenues. To this end a conversion factor is necessary to adjust the per Mcf cost of unsuccessful E&D efforts from the volume of reserves discovered to the volume of gas produced during the year.

The ratio of findings to production vary from year to year. These ratios for gas-well gas were 122 percent in 160, 155 percent in 1961, 180 percent in 1962 and 122 percent in 1963, while the weighted average of findings of all gas was 127 percent of production for the years 1960 through 1964. The appropriate ratio for these purposes is a matter for careful judgment rather than scientific formula.

277,610

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We recognize that what the industry has been spending is not necessarily the desirable expenditure in the public interest. We believe, however, that the level of recent expenditures represents an appropriate basis for determining the ratio which should be adopted. In applying judgment we conclude that the ratios for gas-well gas are the more significant, but they must be discounted in view

of atypical result 1962. If the 1962 figure is brought down to the level for 1961, the four-year average becomes 138 percent. These figures point to an adjustment figure in the range of 35 to 40 percent. In these circumstances we shall utilize the 37 percent figure adopted by the examiner with which all parties have concurred. We believe such a ratio provides a necessary adjustment of the allowance for E&D for new gas-well gas to permit a level of findings reasonably in excess of production. Applying this ratio to the 3.01 cents per Mcf for E&D results in an additional 1.11 cents per Mcf allowance.

The examiner reached a similar result although he associated his allowance, which he termed an "allowance for growth", with a precise reserve-production ratio for the future, a rationale which we cannot accept. However as we have explained, we are satisfied that his conversion factor approximately represents the recent history of findings and is an appropriate conversion factor to permit the recovery of the cost of exploration and development during the year incurred.

The Major Producer Group's exception on this point, which is based on a contention that the ratio of reserves to production should be increased to 20 to 1, is denied. See *supra*, pp. 25-28.

Summary of Exploration and Development Costs

The exploration and development allowance which we here provide as a component of the cost of new gas-well gas will permit the industry to recoup from current pro-

duction all costs presently being incurred in a satisfactory level of exploratory effort. In effect we have found that the industry is now spending approximately 4.12¢/Mcf for exploration and development computed on the basis of the total production of new gas-well gas. Our allowance for E&D provides the industry with the funds to continue the same ratio of E&D in relation to volumes produced.

277,611

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PRODUCTION OPERATING EXPENSE

On the basis of testimony by Witness Roseman on behalf of the California Distributors, the examiner found that a cost of 2.88 cents per Mcf was proper for production operating expense. Witness Park, presented on behalf of Texaco Inc., testified that the amount should be 2.62 cents per Mcf, or 0.26 cent lower. Both Park and Roseman derived their figures from the data on nationwide production costs received by this Commission in response to the questionnaire circulated to Permian Basin producers.

The basic differences between Roseman's and Park's results are two-fold. The first is that in the allocation of overhead expenses Roseman used direct lease cost and expenses, including depletion, depreciation and amortization (DD&A). Park, on the other hand, used direct lease costs and expenses, but excluded DD&A. We find that Park's exclusion of DD&A was proper for the reasons

set forth in discussing this issue in connection with flowing gas in Appendix C, page 3.

The second difference is that Roseman made an adjustment of the production operating cost to reflect national production of condensate and gas, rather than relying strictly on the questionnaire data for production of condensate and gas. His justification for such adjustment, which the examiner adopted, was that the respondents filing questionnaire data produced a disproportionately large amount of lease condensate in relation to their gas production. (They produce one-half of the national lease condensate but only one-third of the national gas-well gas.) Park did not make such an adjustment. We agree with Roseman that this adjustment should be made because of the disproportionate production of condensate. We adopt Roseman's production operation expense allowance but modify it to reflect the proper overhead allocation. Making this modification, the production operating cost is 2.70 cents per Mcf.

277,612

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ADJUSTMENT OF NET PRODUCTION TO MARKETED PRODUCTION

The examiner included no special item in his cost computation to reflect the costs of gas produced but not sold. Witness Park included a 5-percent adjustment which he said was to compensate for waste, for venting, and for gas consumed on the producing property. The

Major Producer Group contends that there should be at least a 2-percent adjustment. The annual reports of the Texas Railroad Commission and the Louisiana State Conservation Commission for 1960 show that in these states, which produce 75 percent of the nation's gas-well gas, less than one-tenth of one percent of the gas was vented and wasted.

We agree with the examiner for the reasons stated at pages 85-86 of his opinion that there is no justification for making any allowance for the negligible amount of gas vented or wasted.

NET LIQUID CREDIT

When gas is produced some of the entrained liquids may condense while the gas is being lifted or shortly thereafter, and some of the liquids may be extracted by processing operations. The producers often receive substantial revenues from the sale of the liquids independently of the price they receive upon sale of the gas, and such liquids are an important item of commerce. Witness Roseman, on behalf of California Distributors, and Witness Park, on behalf of Texaco Inc., both credited the revenues received by gas producers from the liquids contained in the gas to the cost of finding and producing the gas. The Major Producer Group now contends that no liquid credit should be adopted. Staff, on the other hand, has excepted to the examiner's determination that the proper amount of the liquid credit is 2.68 cents per Mcf, net, after royalties and production taxes are deducted, and contends that the proper amount for new gas-well gas is 3.27 cents per Mcf.

As to the basic issue whether it is appropriate to credit the cost of gas with the liquid revenues, we adopt the examiner's views as follows:

> The logic of crediting the revenues from the liquids is that the producer can reasonably expect that, from a proposed expenditure in the generally directional search for and production of gas-well gas, he will receive revenue from the liquids as well as from the gas. Thus he may count against his prospective total cost the expected revenues from the liquids. The remainder represents the revenues to be derived from the gas if the total costs are to be met, and is the cost burden that has to be borne by the gas. Since the price of lease condensate has been relatively stable in recent years[11] and since the credit amounts to only sixteen percent of the price for new gas-well gas adopted herein, it is not likely that changes in the price of condensate will produce significant swings in the price of gas. In these circumstances, crediting the liquids is reasonable for the purpose used here. (Initial Decision, Appendix, B, pp. 88-89.)

The producers' argument to the contrary is essentially that since the Commission does not regulate the sale of

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[11] Average prices for lease condensate were: 1954, $3.01 per barrel Census; 1958 $3.05, Census; 1960 $3.03, Appendix B.

liquids it is improper to credit revenues. This is equivalent to saying that oil-well gas should be priced at the total cost for both oil and gas because we do not regulate oil prices. The argument has been rejected by the courts with respect to crediting of liquid revenues extracted by pipelines.[26]

Witness Roseman's testimony and the presiding examiner's determination as to the amount of the liquid credit were based upon published statistics of the American Petroleum Institute (API) and the *Oil and Gas Journal.* The gross credit is derived by multiplying the condensate production from gas-well gas by the price received for the liquids and dividing this amount by the total gas-well gas production for the year in question. Using the *Oil and Gas Journal* production figures, the examiner concluded that 3 cents per Mcf is a reasonable estimate for the gross lease liquids credit from which he deducted royalty of 12.5 percent and production tax to obtain a net credit of 2.48 cents, exclusive of plant liquids revenue which we shall treat separately.

All of the statistical series point to the conclusion that there has been an increase in condensate production from gas-well gas since 1960, a rate of increase which is greater than the rate of increase in finding and producing gas

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[26] *Panhandle Eastern Pipe Line Co.* v. *FPC,* 324 U.S. 635, 646 (1945; *Cities Service Gas Co.* v. *FPC,* 155 F.2d 694, 703 (CA 10, 1946); *Panhandle Eastern Pipe Line Co.* v. *FPC,* 305 F.2d 763, 767-768 (CADC, 196....), *cert. denied,* 372 U.S. 916.

(277,614)

The fact that the increase in condensate products has outstripped the increase in gas-well gas production reflects the richer content of liquids in the new gas-well gas which is being discovered and the improved separation techniques developed by the industry. The examiner by basing his credit exclusively on the liquid to gas ratio in current production has not taken into account this trend in condensate production. Since we are here concerned with a ceiling price to apply to new gas-well gas, the liquid credit we allow must reflect current and expected experience. We believe that a figure based upon the respondents' responses to the Commission's questionnaire is more nearly representative of current trends. Witness Park determined a gross credit of 3.71 but as was explained with regard to production operating expenses (*supra,* page 54) we agree with the examiner and Witness Roseman that the questionnaire data from which this figure was derived by Witness Park was not fully representative of industrywide production. The questionnaire data reflects a larger production of condensate on a unit basis than do the nationwide statistics. Accordingly, in our judgment, the 3.71 cents per Mcf gross liquid credit should be adjusted downward to reflect this distortion. We believe that taking all facts into consideration the proper gross liquid credit should be 3.50 cents per Mcf. This credit is based upon production which is well within the range of published statistics for 1960 and is in line with the trend in later years toward increased realization of condensate per Mcf of gas.

The gross figure of 3.50 cents after deduction of production taxes and royalties leaves a net liquid credit of 2.90 cents, not including plant liquids, which we here adopt.

In addition to liquids extracted at the well, gas-well gas is also processed at stripping plants. Producers usually share in the revenues from these plant liquids on a percentage basis. Witness Roseman testified that if the producers receive only 20 percent of the liquid revenues it would amount to 0.4 cent per Mcf of gas-well gas produced. The California Distributors and Texaco, who sponsored witness Park, stipulated that for purposes of this case a credit for plant liquids in the range of 0.1 cent to 0.2 cent per Mcf of gas-well gas produced could be used. In light of Witness Roseman's analysis and the trend of richer liquid content which the record reveals we shall adopt the examiner's conclusion that the upper range of the stipulation, 0.2 cent per Mcf, should be accepted as an appropriate plant liquid credit.

The addition of 0.20 cent per Mcf to the 2.90 cents per Mcf net liquid credit gives a total liquid credit of 3.10 cents per Mcf.

REGULATORY EXPENSE

Neither Witness Roseman, for the California Distributors, nor Witness Park, for the Major Producers Group, included in the computation of costs any amount of regu-

latory expense. The presiding examiner, however, included in his computation an item of .14 cent per Mcf for regulatory expense, based on data derived from answer to the questionnaire. Since it appears to be a reasonable estimate and no participant disputes its inclusion, it will be accepted.

277,616

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DEPLETION, DEPRECIATION, AND AMORTIZATION OF PRODUCTION AND INVESTMENT COSTS

Production investment costs include successful well costs, lease acquisition costs and cost of other production facilities. These items were capitalized by the presiding examiner, and we agree. The total of these items will establish the rate base on which a return must be allowed. The amount of the rate base itself must be recovered by the producers by charges for depletion, depreciation and amortization over the period of the economic life of the investment. The procedure we use is to convert DD&A to an Mcf basis and to add an element for return on the production investment per Mcf. We shall discuss separately each item involved in the calculation.

Successful Well Costs

The examiner found that successful well costs amounted to 2.88 cents per Mcf of gas found. He determined this amount by dividing the cost per foot of

successful wells drilled in 1960 by the average of gas reserves added per foot of drilling in a year. The drilling cost per foot was derived from data in the U. S. Bureau of Census, Census of Mineral Industries for 1958, adjusted to 1960 on the basis of the questionnaire data. The total reserves added were derived from the AGA proven reserve statistics.[27]

The Major Producer Group first argues that the Joint Association Survey (JAS)[28] cost per foot of well drilling should be used in place of the 1958 Census data as trended to 1960. In the alternative, they urge that if the 1958 Census cost is used, this cost should not be adjusted downward on the basis of the questionnaire data to arrive at the 1960 cost. They conclude that the successful well drilling cost should be computed at 3.10 cents per Mcf of gas reserves added, rather than 2.88 cents as computed by the presiding examiner.

We agree with the presiding examiner that the JAS statistics should not be used to decide this issue. The presiding examiner has pointed out that the companies included in the JAS were not selected on a random basis, and that filling out and returning the JAS questionnaire was voluntary. The results thus reflect a considerable

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[27] Identified in this proceeding as Bureau of Mines *Minerals Yearbook*, Vol. II (which is a reprint of the AGA data). The footage used with this data was obtained from *World Oil* magazine.

[28] The JAS is a survey by three industry trade groups and is based on a questionnaire mailed by these groups to all their member companies.

amount of self-selection. Due to the method of selection there is no assurance that the sample is characteristic of the industry as a whole and it should not be used in preference to the 1958 Census, even though cost based upon the 1958 Census was adjusted by trending to determine the comparable 1960 cost.

In our discussion of dry-hole costs we have already dealt with the question whether cost derived from the 1958 Census may properly be trended on the basis of questionnaire data to determine comparable 1960 costs, and affirmed the examiner on this point. We believe it is not only appropriate but necessary to make the same adjustment in this connection. The exceptions in this regard will therefore be denied.

Lease Acquisition Costs

Witness Roseman, on behalf of California Distributors, computed lease acquisition costs at 0.76 cent per Mcf for gas found. In common with all other witnesses on this subject, he determined the cost per Mcf of lease acquisitions on the basis that such cost is directly related to successful well drilling cost. He found that the appropriate figure was 26.4 percent on the basis of data collected in a survey by the Chase Manhattan Bank and data contained in the 1958 Census.

The presiding examiner accepted Roseman's computation of 0.76 cent per Mcf. The Major Producer Group

excepts to this finding, and contends that Witness Park's computation of 1.15 cents per Mcf should be used. Park computed his figure on the basis that lease acquisition cost is 40 percent of successful well cost per Mcf.

We agree with and adopt the presiding examiner's analysis of this question set forth in Appendix B to the initial decision, pages 80-83. The adopted portion, together with an additional analysis reinforcing our conclusion here, is set forth in Appendix B to this opinion.

Cost of Other Production Facilities

The examiner approved 0.31 cent per Mcf for this item which includes lease equipment, related lease facilities and apportioned overhead investment. The 0.31 cent figure is supported by the testimony of Witnesses Roseman and Park, but for different reasons. Witness Park's recommendation was an integral part of a broader presentation which we have not accepted and for that reason we rely on the testimony of Witness Roseman. In substance, Witness Roseman's testimony is that the respondent's gross investment in these items approximates 8½ percent of the gross investment in leases and wells attributable to non-associated gas, and that a comparable percentage of the previously determined lease and well costs should be allowed for these items. We find the amount to be reasonable and we shall affirm the examiner's finding on this point.

Allowance for Growth in Investment

The Major Producer Group contends that in his computation of production investment costs the presiding

examiner should have included an allowance to reflect future increases in investment. We believe

the examiner correctly excluded such an adjustment. Production investment costs are capitalized and recouped, with a return realized from the sale of gas over the period of the life of the investment. This investment is stated in terms of an amount per Mcf of gas found. While the total investment may grow, there is nothing in this record to support a conclusion that there will be an increase in the amount invested per Mcf of gas found. Accordingly, we believe there is no basis for any additional amount as an allowance for growth in production investment costs.

Period of Recovery of Investment

A return must be allowed upon the investment for the average period of recoupment. Having determined the total production investment cost to be 3.95 cents per Mcf, the presiding examiner then estimated that the average period required for return of each dollar of that investment will be 10 years after the resulting gas begins to flow. He reached this conclusion by assuming that the gas will be totally depleted in 20 years, the normal life of a contract, and that the depletion will take place in an equal amount each year. The Major Producer Group and The Superior Oil Company contend that the true

period of depletion is at least 22 years, and that this period rather than 20 years should be the basis of calculation.

These respondents are correct in pointing out that the period of well depletion is somewhat longer than 20 years. More than offsetting, however, is the fact that wells are not depleted uniformly over their producing life. They produce a greater output of gas and condensate during the first years of depletion. Production usually begins to decline some 7 to 12 years after the well begins to flow until, during the last years of depletion, the well is producing only a fraction of its flow in earlier years. While exact figures are not available, it appears that the additional years of minimal production, not included in the examiner's computation, are more than offset by his computing depletion at an even rate rather than taking into account the higher production in early years and the greatly lowered production at the end of the period. Accordingly, the exceptions on this point will be denied.

Lag

Some of the production investment costs must be made in advance of the time that gas begins to flow. Lease acquisitions are often made a substantial time in advance. Expenses for successful wells must be incurred before any gas can be produced. To allow for this lag between investment and first realization of revenue from sale of the re-

sulting gas, the presiding examiner allowed 1 year of so-called "lag time" in addition to the 10-year period in which the average dollar of investment will be recouped after production begins.

The California Distributors urge that no lag period be included. They contend that the investment of funds before gas begins to flow is more than offset by the fact that some of the investment is not made until after gas has been in production for some time. They refer to this as "negative lag."

The Major Producer Group, on the other hand, contends that the lag should be from 3 to 5 years, and that the 1-year period allowed by the examiner is insufficient.

While it is generally conceded that a time gap does exist between the outlays for some productive investment and the initial receipt of income, the evidence in the record is general and vague insofar as it concerns a specific time period. Moreover, this general testimony is offset to a certain extent by the evidence of investment which does not take place until gas has been in production and evidence that some items will be used for only part of the time in which a return will be allowed. There is no precise computation of the average amount of expenditures involved in either the lag or the "negative lag," or of the amounts of time by which these expenditures precede or follow the date when gas begins to flow.

Geological and geophysical expenses and exploratory overhead, both of which may be expended several years before a well begins to produce, are not ordinarily ac-

counted for as part of production investment costs. They are part of exploratory and development costs which are

treated as expenses by the producers in the year in which they are incurred. Successful well drilling costs are approximately 73 percent of the production investment costs. These would ordinarily be incurred within the one year lag before gas begins to flow which the examiner has allowed. Lease acquisition costs may occur earlier, but these are little more than 19 percent of the total production investment costs. The cost of other production facilities, which is approximately 8 percent of the total production investment cost, as here determined, would be incurred largely within the one-year lag period.

Taking into consideration the evidence of both the positive and negative lag, we believe that the presiding examiner's determination on this point should be upheld.

RETURN ALLOWANCE

Rate of Return

Respondents urge the adoption of a rate of return in the range of 16-18 percent on average net investment. In support, they refer to returns previously allowed in producer and pipeline litigation and to the traditional and current earnings experience of numerous industrial and utility categories. Respondents' principal argument is that the risks inherent in exploration are voluntarily in-

curred and extraordinary and they must be recompensed in the rate-making process. They also argue that the discounted cash-flow analysis is the keystone to the producer return issue. The producers also stress the time lag between investment of funds and receipt of income.

Staff, joined by the California interests, presses for a 9½ percent return on average net investment which translates into 10½ percent on common equity. Staff offered extensive testimony which focuses heavily on the earnings experience of integrated producers, who supply the bulk of the natural gas production. Staff supports its reliance on the experience of the integrated producers partly by claiming there is no proof that their non-production departments are less risky than their production departments. Staff recognized the geological

risks inherent in exploration but considers them to a degree offset because of the producers' alleged ability to avoid income taxes, their low-debt capital structure, and the opportunity, implicit in group regulation, for low-cost producers to achieve higher than average returns. For these reasons, Staff concludes that a return must be set in this proceeding which is somewhat lower than that which would be deemed appropriate in the context of individual regulation.

In determining an appropriate rate of return, the Commission must operate within long-accepted judicial

guidelines. Many of them, although established in the context of individual company regulation, apply with equal validity to the *en masse* regulation we have adopted herein. Simply stated, the courts have consistently held that the return must be sufficient to attract new capital, be in line with that earned by comparable industries, *e.g., F.P.C.* v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944); *Bluefield Water Works and Improvement Co.* v. *F.P.C.*, 262 U.S. 679 (1923), and most significantly, be determined, not through the automatic application of formulae, but through informed judgment taking into account all relevant facts, *e.g., State Corp. Commission of Kansas* v. *F.P.C.*, 206 F.2d 690 (CA8 1953), cert. denied, 346 U.S. 922 (1954); *Washington Gas Light Co.* v. *Baker*, 188 F.2d 11 (CADC 1950), cert. denied, 340 U.S. 952 (1951).

As a starting point in our analysis, we turn to the financial requirements and experience of a sector of the gas industry with which years of regulation have made us familiar, the natural gas pipelines. The transmission sector is an immediate adjunct of production, and the two have evolved contemporaneously. An examination of recent transmission company rate proceedings indicates that representative companies

are currently being allowed returns on net investment in the 6.0-6.5 percent range, with the preponderance between 6.25-6.5 percent. While we have recently been em-

phasizing the overall return, it is instructive that a 6.25-6.5 percent return on transmission net investment translates, considering current capitalization patterns, into a yield on equity of from 10.0 to 12.0 percent. Although this yield is by no means dispositive of the issue before us, it places the issue of an appropriate rate of return for gas production in a more meaningful context, especially in view of the fact that producers generally are 85 percent equity companies. In addition, production operations inherently involve a greater degree of risk than the transportation of gas.

The difference in the degree of risk is highlighted by the fact that the construction and operation of transmission lines are authorized only upon the issuance of certificates of public convenience and necessity, and these, in turn, require a showing of economic feasibility. *Northern Natural Gas Co.*, 28 FPC 1155 (1962). By contrast a producer who is exploring for new gas is relying largely on the law of averages, especially under the area rate approach.

Transmission companies generally have assured sources of supply, traditionally under at least twenty-year contracts. They are generally able to shift to their purchasers the burden of their costs, and they have a minimal labor problem. Considering these factors, together with the projected continuation of a 3.5 percent growth in consumer demand, the 6.25-6.5 percent overall return and the 10 to 12 percent yield on equity for pipelines can be considered as applying to a relatively safe investment, at least by comparison with gas production.

In comparing the allowable returns on production with the returns previously allowed in transmission proceedings legal precedent and financial requirements dictate that if unusual risks are inherent in production, a greater return should be allowed on investments therein in the absence of record evidence to support a different conclusion. See, *e.g.*, *F.P.C.* v. *Hope Natural Gas Co., supra; F.P.C.* v. *Natural Gas Pipeline Co.*, 315 U.S. 575 (1942); *Bluefield Water Works and Improvement Co.* v. *F.P.C., supra; Wilcox* v. *Consolidated Gas Co.*, 212 U.S. 19 (1909). It is beyond question that the business of exploring for natural gas and, to a lesser extent, its production, is fraught with uncertainties foreign to its transmission. Justice Jackson pointedly expressed this fact in his oft-quoted dissenting statement in the *Hope* case, and the Commission has repeatedly recognized it. Thus, we said in *Phillips*:

> It is clear that the risks of this business [exploration and development] are greater than those of an electric utility or natural gas pipeline. 24 FPC at 572.

We have also noted the special risks involved in production operations:

> The producer must invest his funds prior to ascertaining whether he will have anything to sell or whether, if he does, he will have an adequate market. *Id.* at 543.

(277,624)

And later in *CATCO:*

> We are fully cognizant of the risks of drilling for gas and the need to encourage continued exploration and production. 27 FPC at 106.

277,625

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And still later in *Southern Natural Gas Co.*, 29 FPC 323, 336 (1963):

> It is well recognized that a series of dry holes or even a single dry hole may bankrupt an independent producer, and it is equally well recognized that an independent producer who has the misfortune to discover high-cost gas may very easily find it impossible to dispose of such gas at a price which returns more than a small fraction of his costs of discovery and development.

The principal uncertainty lies in finding gas in commercial quantities, and is emphasized by the record evidence that producers, while seemingly able to a degree to direct their searches for particular hydrocarbons, have no assurance that any hydrocarbon will be found. The risk of a dry hole — or noncommercial well — is one that has characterized the production activity since its inception. That the risk is not merely theoretical is borne out by the questionnaire data compiled in Staff exhibit 142 which reveals that Permian respondents in 1960 spent approximately $212,342,000 on geological and

geophysical expenses, $114,284,000 on lease rentals and $271,576,000 on dry holes. While it is true that in the aggregate we allow these costs as an operating expense, the uncertainty whether productivity will meet the industry average nevertheless remains as a risk for each individual producer and it must be recognized in the rate-making process.

There is another risk in the production operations which our allowance for a rate of return in this proceeding must reflect — the risk of finding gas of less than pipeline quality. The record reveals that the greater percentage of the gas in the Permian Basin does not fully meet the pipeline quality standards prescribed herein. The details respecting quality adjustments are discussed *infra* at pages 94-103. While we have provided upward adjustments for new gas-well gas with above average Btu content, nevertheless there remains the risk that any gas found can be sold only at an adjusted ceiling price which involves a substantial discount from the ceiling prices for gas of pipeline quality prescribed herein. Such risk is a special factor that must be considered in establishing the rate of return for the Permian Basin.

Agreeing that production operations involve risks which must be recognized in our allowance for rate of return, yet we conclude that the risks are not as great as the producers claim. The producers' case for a 16-18

percent rate of return ignores the fact that there is a degree of predictability to production operations as evidenced by the fact that the industry as a whole has maintained over extended periods a consistent record of new discoveries and added reserves. The producers statistical support for a 16 to 18 percent return rests on data that contain conspicuous infirmities. As pointed out by the examiner, Witness Morton's statistical presentation contains only one instance of an 18 percent rate of return on capitalization. We affirm the examiner's conclusion that Morton's sample is unrepresentative.

The return producers seek is greatly in excess of the recent earnings experience of even the nonintegrated producers. It is three-fold the return allowed on transmission investments and it would produce a yield on common equity of approximately 20 percent. Such a return is neither typical nor necessary, and must be rejected.

We have already discussed the "true yield" method for determining capital cost which expresses the discount rate equating the value of a stream of future revenue with the cost of the initial investment generating that stream. It is employed herein by the producers to demonstrate the earnings rate disparity between it and the conventional method which allows a return on net investment. The witness advancing this unconventional approach has merely urged that the disparity between book yield and "true yield" be recognized in a larger return allowance and provided little in the way of support for the application of his alternative method. In these circum-

stances, his approach cannot be used in resolving the rate of return issue in this case.

We now turn to the earning experience of the production industry to fix the return to be allowed in this proceeding. Staff witness Shaffner's Exhibit 176 analyzed in Schedules 11 and 12 the 1957-1961 rates earned by two classes of producers: those that were principally engaged in production, and those that were also engaged in refining and marketing. The schedules, based on *Moody's Industrials and Annual Reports to Stockholders,* were limited to companies with interstate sales to pipelines in

excess of 2,000,000 Mcf annually, with actively traded common equity, and with a policy of making periodic reports of their earnings posture.

The Staff Exhibit 176, Schedule 11, reveals that the average returns for nine companies confined to production functions in each of the years 1957-1961 were, respectively, 13.9, 10.9 (including an .8 percent return for one company), 12.4, 11.6, and 13.2 percent, which produced an average of 12.4 percent, and a five-year median of 10.9 percent. When only the experience of the seven Permian producers is reflected the returns for the same years are as follows: 15.0, 12.4, 13.9, 12.5, and 13.4 percent, making an average of 13.4 and a median of 11.3 (Exhibit 176, Schedule 12). These

staff figures are consistent with respondent witness Morton's Exhibit 220, showing that 13 producers engaged solely in production, including six not covered by 13.0 and 14.4 percent over the same period. This produced an average return of 14.5 and a slightly lower median of 14.4 percent.

Both the Staff exhibits and the presentation of Witness Morton were limited in the number of individual companies covered; the latter also employed subjective considerations in selection and was forced to report on a less comparable basis. Nevertheless they are the best record indication of what the production function traditionally returns. We conclude that they are entitled to heavy consideration in the decisional process in this case.

Witness Shaffner's second category was comprised of 26 integrated producers. The average return experience for these companies was 10.0, 7.9, 8.1, 8.2, and 8.2 percent for the indicated years, which gave a five-year average of 8.5 percent and a median of 8.1. When limited to the 24 integrated Permian producers, the figures decreased slightly: 9.9, 7.8, 8.0, 8.0, and 7.8 percent, for a five-year average and median of 8.3 and 8.1 percent, respectively.

On a general average basis, the resulting return was 9.5 percent for both the national and Permian producers. On

an average weighted by capitalization basis, both national and Permian-only, the resulting return was 9.3 percent, reflecting that the total capitalization for the 26 integrated companies was over 40 times that of the nine non-integrated companies.

The Shaffner study of the returns of integrated producers standing alone fails to make a persuasive showing that the results are the best evidence of the financial needs of the gas operations of the companies involved. It covers the most widely diversified segment of the industry, those whose revenues were derived from the sale of petrochemicals, fertilizers, plastics and gasoline, as well as from transmission, distribution, real estate and manufacturing enterprises. The exhibits in the record, and the sources upon which they are based, offer no ratio of the integrated company oil and gas production revenues to total revenues, although they do reveal that revenues generated by natural gas sales to pipelines accounted for but 2.22 percent of total revenues. Without a departmental segregation of costs and revenues, it is impossible to calculate production department returns. It may be that on a different record the returns of integrated producers may be shown to be highly relevant but without any assurance that production returns approximate overall returns, we cannot automatically attribute the latter to the former. Accordingly, while we are persuaded that integrated producer returns are relevant to the instant issue, we are not persuaded that the Shaffner exhibit sufficiently weights production operations in his recommended return of 9.5 percent.

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After weighing all the evidence on the issue we believe a return of 12 percent is appropriate in light of the considerations previously discussed and the presentations in this case, particularly the testimony of witnesses Shaffner and Morton with respect to the returns by nonintegrated producers in the Permian Basin. A return of 12 percent on production activities protects gas consumers against excessive prices but it is not so low that it fails to respond to the needs of the industry. It also considers the needs of the smaller independent who traditionally drills much of the Permian exploratory footage and his limited resources to weather even a brief series of unproductive expenditures. It may

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be that another result may be reached on a different record but in this first area rate proceeding we believe the record points to a return of 12 percent and it is therefore adopted.

The presiding examiner, having determined that the total production investment would be recouped over an average period of 10 years beginning an average of 1 year after investment, correctly concluded that the total return to be allowed on each Mcf of gas should be based on an investment base that is 11 times the production investment per Mcf found. As the production investment was found to be 3.95 cents per Mcf, the investment base here is 43.45 cents. The annual return per Mcf should be

computed by multiplying 43.45 cents by the 12 percent rate of return, producing a figure of 5.21 cents per Mcf.

Return on Working Capital

To the return on net investment must be added the return on a working capital allowance. While in this proceeding the return on the allowance is a small item, it raises a policy question for decision.

Distributor witness Roseman presented a working capital computation in Exhibit 224 which follows the traditional utility formula of allowing in the rate base for a 45-day lag in collections; that is, a return is allowed on the sum of one-eighth of annual production operating expenses, one-eighth of annual exploration expenses, and amounts invested in supplies, materials and prepayments allocated to the exploration and production functions. The resulting allowance is 1.63 cents per Mcf which, at a 9½ percent rate of return, gives a .16 cent return. The presiding examiner accepted the method but, substituting 12 percent, allowed a .20 cent return.

The producers contend that the utility formula is inappropriate for the producing industry because it excludes funds that must be kept available for lease plays, drilling failures and exploration. They point out that their ratio of net plant to total capitalization is far smaller than in the transmission industry, and consequently, recurring cash needs, which are not covered by the return on net

investment, become more significant. The producers advocate a "balance sheet formula" which would allow a full return on the current net assets. They conclude that a representative allowance would be either 23 percent of total capitalization, which is the ratio of actual working capital to total capitalization for the thirteen non-integrated producers covered in their Exhibit 220, or 17 percent, which purportedly represents the ratio found in the Chase Manhattan Bank 1960 study of the actual cash portion of current net assets to net plant for the integrated companies. The Staff reply brief, however, correctly points out that the actual cash portion is but 6.7 percent, the other 10.3 percent representing marketable securities.

Staff and the distributors attack the balance sheet formula. They contend that it inappropriately allows a return on such items as total cash on hand, marketable and capitalized securities, accounts and notes receivable, and — in the case of the integrated producer — current assets applicable to refining and marketing. They argue that because net current assets have no reasonable relationship to the function of the working capital allowance, the balance sheet formula has been uniformly rejected by this Commission and the Courts. Staff concludes that the Commission has regularly employed the utility formula for producers and that other sources assure the availability of sufficient funds. Consequently, no further allowance is appropriate.

The Commission was first presented with a balance sheet approach in *Cities Service Gas Company*, 3 FPC 459 (1943), where it rejected the method as being "* * * unsound and inherently fallacious for ratemaking purposes." 3 FPC at 478. The case was affirmed, 155 F. 2d 694 (CA10), cert. denied, 329 U.S. 773 (1946). The Commission reaffirmed this conclusion in *Northern Natural Gas Co.*, 11 FPC 123 (1952) and the reaffirmance was specifically upheld in *Corp. Comm'n of Kansas* v. *F.P.C.*, 206 F.2d 690 (CA8 1953), cert. denied, 346 U.S. 922 (1954). The method was also rejected in *Panhandle Eastern*

Pipeline Co., 13 FPC 53 (1954), *rev'd on other grounds, City of Detroit* v. *F.P.C.*, 230 F.2d 810 (D. C. Cir. 1955). The balance sheet approach now urged upon the Commission incorporates the same flaws as found in the previous versions of this method. As herein presented, it is insufficiently refined and meaningful to be a legitimate regulatory formula, and we see no reason to depart from the sound reasoning of the *Cities Service* decision.

We are convinced that the balance sheet approach must be rejected and conclude that the four additive factors in the utility formula — cyclical expenses, materials, supplies and prepayments — are justified components of a working capital allowance for the producing industry, and that the formula is appropriate for calculating these

factors. We appreciate, however, that the erratic nature of individual company lease acquisitions, the competition among producers for attractive leaseholds, and the established practice of the industry to generate its own capital, demand that additional liquid sums be kept available. Accordingly, a compensatory "lease play" return must be allowed on reasonable amounts in excess of the working capital allowance based on the traditional utility formula.

Such funds in reasonable amounts are not idle or dormant in a meaningful sense. They are being employed as the exigencies of the business demand: in ready reserve for expenditures upon which the contribution of the industry depends. Such funds are not surplus, because they could not be dissipated without adverse effect on the exploratory effort. Moreover, there is no likelihood that they will be retained merely to inflate rate bases. Producers are relatively assured of receiving a return on funds invested in securities, and they have a fair opportunity of receiving a return on funds invested in the producing industry. Perhaps the most persuasive reason why excess sums are unlikely to be retained is that producers reduce their tax liabilities by a continued investment in the industry; the depletion allowance, by law, can offset no more than 50 percent of net income from a productive lease. This immediate tax benefit accruing from reinvestment far outweighs any incentive to mere accumulation.

We find that the producers must be given a return on the funds retained for lease play in addition to the 0.20 cent per Mcf return allowance computed under the traditional utility formula. An exact amount for this additional allowance is difficult to determine from the present record. Presuming that the producers should be allowed a return on liquid funds on hand equivalent to one and one-half times their per Mcf expenditures for lease acquisitions, return on the allowance for lease play would be approximately 0.15 cent per Mcf.[29] Future proceedings may elicit a more precise method for computing this amount.

For the purposes of this case, 0.15 cent per Mcf will be added to working capital as a lease play return allowance, making the total return on working capital 0.35 cent per Mcf.

ROYALTIES

Both Witness Roseman and Witness Park included royalties at the rate of 12.5 percent in their computations of cost. The presiding examiner accepted this figure and no participant demurs to the inclusion of such an item or to the 12.5 percentage. The examiner's figure of 2.11 cents per Mcf will be adjusted to 2.05 cents per

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[29] As determined herein, the annual lease acquisition cost per Mcf is 0.76 cent. A lease play allowance based on a 12 percent rate of return on one and one-half times this 0.76 cent per Mcf amount would be .137 cents per Mcf.

Mcf to reflect the changes in the total amount on which the 12.5 percent royalty is computed.

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PRODUCTION TAXES

The present Texas production tax is at the rate of 7 percent of lease revenues. Production taxes in New Mexico are somewhat lower than in Texas. The presiding examiner used a weighted average of Texas and New Mexico production taxes, which he computed to be 6.42 percent after taking into account the latest increase in New Mexico taxes.

We think that reasonable local taxes are a valid basis for a difference in ceiling prices between one area and another and if reasonable the tax applicable in each state should be applied to the gas produced in that state. The 7 percent tax in Texas is at approximately the maximum level of taxes which we have allowed to be passed on by the producer to the purchaser. Accordingly, the full amount of taxes actually incurred either in Texas or New Mexico will be allowed as a component of the total price per Mcf of gas. Since the greater part of gas produced within the Permian Basin is subject to the jurisdiction of the State of Texas, all ceiling prices set forth in this opinion will be stated in amounts applicable to gas produced within the taxing jurisdiction of that state. However, the ceiling price for sales in New

Mexico will reflect the applicable tax in that state and will, accordingly, be at lower levels.

In the event of any increase in taxes in Texas or New Mexico, the Commission will consider whether ceiling prices shall be increased and, if so, to what extent.

The ceiling price here established will be the total amount to be paid by the buyer of gas, including all tax reimbursements provided by contract.

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INCOME TAXES

Respondents presented no evidence that any income tax allowance should be included in the computation of cost of new gas-well gas. Their witnesses, Park and Keane, included no such allowance. At stated by the examiner, the testimony of Staff Witness Lyon shows that if the industry's growth is considered, there will be no Federal income tax liability at any return up to 15 percent. The Major Producer Group argues that 0.6 cent per Mcf should be included in the cost computation, representing income tax liability upon a return at the rate of 12.5 percent based on testimony by Witness Roseman. However, Roseman qualified his calculation by stating that many major companies in the past have been found to pay no income taxes, and that there is no evidence that taxes would in fact be paid. He further indicated that his computations should be revised in the light of additional data which was never introduced into the record.

In these circumstances we think the analysis of Witness Lyon was properly accepted by the examiner and we affirm his conclusion on this issue.

THE RATE FOR NEW GAS-WELL GAS

As we have stated the basic standard for determining the price of new gas-well gas is the cost-finding technique we have employed herein. However, in determining the price for each particular area the Commission must, of course, consider other relevant factors in the area. The factors which are commonly considered in the design of rates include the impact of the prescribed rate on existing rate structures, the quality of the gas in the area, the historical prices in the area and other such factors.

The presiding examiner made two adjustments from his cost base on account of such factors in designing his ceiling price for the Permian Basin. Both were of major size. One was a downward adjustment of 1.25 cents in the ceiling price for new gas-well gas (his so-called "location factor") to reflect the fact that historically the average initial price for new gas in the Permian Basin has been lower than the comparable price in the 7 southwestern

states.[30] The second adjustment was in the other direction and consisted of an addition of 1.0 cent as a so-

[30] He used the seven southwestern states because figures for continental United States were not available.

called "gold standard" to reflect the fact that much of the gas in the Permian Basin was of less than pipeline quality and his view that such a premium should be permitted for pipeline quality gas.

We do not believe that either of these adjustments is appropriate. Rates should of course be designed so as to minimize any disturbances of existing pricing patterns to the extent possible consistent with the basic regulatory standards. However, nothing in the record in this case suggests that the ceiling prices we are prescribing for the Permian Basin require any such adjustments. No adjustment for "location factor", whatever that vague concept may mean, is required or is appropriate in this proceeding, either in the amount prescribed by the examiner or in any other amount.

As to the "gold standard" adjustment, we have made clear that the ceiling prices prescribed herein apply as true ceilings for gas or pipeline quality and we have accordingly prescribed standards of pipeline quality. These standards provide for both upward and downward adjustments in the ceiling price for new gas-well gas. The record is deficient as to the overall financial impact of these adjustments but in our determination of rate of return we have recognized that producers in the Permian Basin incur the risk that the gas they find and produce may not command the ceiling price. The absence of any definitive record support for a "gold standard" adjustment coupled with our reflection of the quality problem in fixing the rate of return satisfies us that area revenue requirements will be met.

In summary, when all of these factors are considered there is no justification in this area for any adjustment of a cost-determined ceiling price. We state again

that the ceiling price we are here establishing is for the Permian Basin and that it is entirely possible that in other areas non-cost considerations may require adjustment of the cost figures in establishing the ceiling prices. We hold only that no such adjustments are required in the Permian Basin on the basis of this record. Accordingly we shall round off the cost determined price of 16.43 cents and prescribe a ceiling price for new gas-well gas of pipeline quality in the Permian Basin at 16.5 cents per Mcf at 14.65 psia for gas produced and sold in Texas. The ceiling in Texas includes a production tax of 1.01 cents, which we round off to 1.0 cent, leaving a rate less production taxes of 15.5 cents. For gas produced and sold in the three New Mexico counties, Chavez, Lea and Eddy, the ceiling price shall therefore be 15.5 cents at 14.65 psia plus the applicable production taxes in effect as of the date of this opinion. These prices will apply to residue gas derived from new gas-well gas (see discussion pp. 75-76).

RATIONALE FOR A UNIFORM CEILING PRICE FOR FLOWING GAS

Casinghead Gas

Casinghead gas is the common name for gas produced from oil wells in conjunction with the production of oil.

For purposes of the application of our ceiling prices herein, we shall follow the existing classification of casinghead gas by the appropriate state agency. Casinghead gas is often higher in Btu content than either residue or gas-well gas, and usually contains valuable liquids which are extracted before the gas is delivered to a pipeline. Casinghead gas is often delivered at low pressures, sometimes as low as 5 psig. Since oil wells in the Permian Basin are subject to restraints imposed by state regulation upon the amount of oil produced, casinghead gas can be obtained from a given well only for the period each month that oil is under state oil production controls. Correspondingly since oil is the major product of an oil well, taking the casinghead gas cannot be deferred for any length of time for the buyer's convenience; it must be taken at the time the oil is produced, and the amount of gas is related to the oil production.

Accordingly casinghead gas is not subject to the exclusive control of the buyer as to time of delivery. Ordinarily, however, processing plants will schedule deliveries from the various wells which they service in such manner as to maintain a substantially even output, so that irregularities in deliveries from particular wells are overcome to some extent for the pipeline purchasers from the processing plants. Nevertheless, this limitation on the deliverability of casinghead sometimes requires the pipelines to draw on additional gas-well gas to meet their commit-

ments, and gas-well gas sources therefore provide a valuable flexibility in meeting the peak requirements of the pipelines.

Most of the casinghead gas sold in the Permian Basin is sold to processing plants under percentage contracts, which provide that the processors shall pay to the producers a stipulated percentage of the price which the processors receive upon sale of the residue gas plus an agreed percentage of the proceeds of sale of the extracted liquids. Under these arrangements, the price paid by the processor is immaterial to the consumer so long as the price of the residue gas conforms with the ceiling price established for such gas in this proceeding. The processor is controlled by certificate and rate schedule filings and producers who sell casinghead gas under such percentage contracts are not permitted to file rate schedules with this Commission (Regulations Under the Natural Gas Act, Sec. 154.91(e)). So far as such producers are concerned, any separate ceiling price for casinghead gas would have no application.

The second major type of contract under which casinghead gas is sold in the Permian Basin is the so-called Spraberry or El Paso contract. These contracts provide for the purchase of casinghead gas by a pipeline which processes the gas, pays the producer a percentage of the proceeds from the sale of the extracted liquids, plus a fixed price for the residue gas delivered to the

pipeline. The examiner held that the payment arrangements provided for in the Spraberry contracts must be discontinued. He fixed ceiling prices of 10 cents per Mcf for old casinghead gas and 11 cents per Mcf for new casinghead gas, to be paid for the raw stream (including liquids) without any additional compensation to the producers in the form of a percentage of the liquids or of the price received for them. In effect he outlawed the Spraberry contracts and declared that only a flat amount, limited by the separate casinghead gas ceilings, could be paid for casinghead gas purchased under the Spraberry contracts.

The Major Producer Group has taken strong exception to this ruling, contending that pipelines will not be able to purchase casinghead gas if the presiding examiner's proposal is implemented because producers would then prefer to sell to the processors under percentage contracts. They also assert that the Commission has no jurisdiction over the division of the extracted liquids.

We believe the presiding examiner was correct in holding that the sale of the casinghead gas to the pipeline under the Spraberry type contract is subject to Commission jurisdiction, and that this Commission has the power to regulate the price for the raw gas purchased even though it may include the heavier molecules which can easily be liquified. The form of the contract provides for the transfer of title to the gas as casinghead or raw

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stream gas but the method of payment is based upon a specified price per Mcf for the residue volumes of gas and a percentage payment of liquid revenues. The Commission has no jurisdiction over the price at which liquids are sold but if payment for the raw stream is made in whole or in part on the basis of a percentage of liquids or liquid revenues, the Commission may still consider the liquid credits in controlling the amount of the payment for the gas.

The fact that the transaction is subject to our jurisdiction does not mean, however, that we must reject a common form of contract which has been found useful in the industry. We believe that regulation should utilize industry practices developed by the parties to meet industry problems to the extent consistent with maintaining effective regulation. The Spraberry contracts govern approximately 20 percent of the gas sold in the Permian Basin, and we do not think they should be discarded unless it can be shown that they give rise to abuses or evasions, or result in unjust and unreasonable prices to consumers. So long as the cost to the pipelines for residue gas under the Spraberry contracts does not exceed the applicable ceiling price for gas of similar quality, we see no reason to require the elimination of the Spraberry contracts.

There is no evidence in this proceeding that the pipelines' cost of gathering and processing the casinghead gas

purchased under Spraberry contracts is greater than the revenues realized by the pipeline from the liquids extracted. As long as the liquid revenues to the pipeline equal or exceed the processing and gathering costs the consumer will be adequately protected by the ceiling here established for residue gas. If the cost of gathering and processing exceeds the pipelines' liquid revenues by an amount which, if added to the price paid for the residue gas, would exceed the ceiling price applicable to residue gas of similar quality, and appropriate reductions of the price cannot be negotiated, the purchasing pipeline may petition the Commission for relief pursuant to Section 5(a) of the Act by ordering an appropriate reduction in the price the pipeline pays for such residue gas.

Aside from gas sold under percentage contracts and Spraberry type contracts, only a negligible amount of casinghead gas is sold in the Permian Basin. In 1960, only three such contracts involved sales in interstate commerce of Permian Basin casinghead gas to pipelines. These contracts involved total revenues of less than $200,000 in 1960. The impact of these contracts upon prices to be paid by the ultimate consumer is *de minimis*. The contract prices were all under 14 cents. Additional reductions in price for quality deficiencies would reduce the actually realized prices still further. The effect of these contracts is too small to warrant the establishment of a separate ceiling price for casinghead gas.

Aside from percentage contracts, there are also few contracts for sales in interstate commerce of casinghead gas to producer-owned processing plants in the Permian Basin. These contracts will have no direct effect upon the cost to the pipelines and the ultimate cost to the consumer, since the resulting residue gas sold by the processing plants will be subject to the ceiling price herein established for residue gas derived from casinghead. In the event it should be determined that these contracts have a sufficient effect upon the cost of the processing plants so that the latter must seek relief before this Commission, we may then consider whether the prices under such contracts must be subjected to additional regulation. The record in this proceeding does not reveal the need for any such regulation. In general, the prices under such contracts are at sufficiently low levels so that the processors should be sufficiently protected. We establish herein a ceiling price for all gas (except new gas-well gas and residue derived therefrom) which will be applicable, of course, to such contracts.

We believe it is of great importance to simplify the system of area rate ceilings to the extent practicable consistent with an effective system of price controls. In this light we conclude that there is no need for a separate casinghead gas ceiling in the Permian Basin at this time. In the future, should the lack of such a ceiling be found to encourage evasions of the general price ceiling, a

separate ceiling price for casinghead gas may be established. With respect to the Spraberry contracts and all other contracts which, in addition to a payment for residue gas, call for payment for a percentage of liquids or turning over a percentage of the liquids to the producer, any alteration in the price paid for the residue gas or the percentage of the liquids due to the producer will be considered a rate change which must be filed with this Commission and the right to make such rate changes will be subject to the moratorium on rate increases imposed herein. Future contracts embodying such provisions are to be certificated only where the liquid percentage to be retained by the processor or the pipeline equals or

exceeds the cost of gathering and processing performed by the processor or pipeline, or where the price to be paid for the residue gas is reduced below the applicable ceiling sufficiently to offset processing and gathering costs in excess of the value of the liquids retained by the processor or pipeline. In the absence of a contrary showing, percentages similar to those now in effect will be assumed to be compensatory and will be approved in future contracts for comparable gas under comparable circumstances.

Residue Gas

Residue gas is the gas remaining after casinghead gas or gas-well gas has been processed to remove liquids pres-

ent in the raw gas stream in the form of vapor or droplets. Only three to four percent of the residue gas produced in the Permian Basin is derived from gas-well gas; between 96 and 97 percent comes from casinghead gas.

Residue gas in the Permian Basin is delivered at somewhat lower pressures, on the whole, than is gas-well gas. Most residue gas is delivered at pressures below 800 pounds, but deliveries of gas-well gas at pressures of 1,000 pounds and up are not uncommon. The cost of raising the pressure of gas to a given point is not proportionate to the added pressure, but is determined by the number of stages of compression (and the compression ratio) necessary to create the desired pressure. To raise the pressure of gas from 600 pounds to 800 pounds will normally cost little more than to raise it from 700 pounds to 800, since in each case only one stage of compression will be necessary.

For purposes of applying the area prices prescribed herein, the ceiling price for new gas-well gas will be applicable to residue gas which is derived from new gas-well gas and the ceiling price for all other gas will be applicable to residue gas derived from casinghead gas or old gas-well gas.

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We regard our determination that all gas should be priced on the same basis as old gas-well gas (except for the top ceiling we have established to encourage the

search for new gas-well gas which is applicable to such gas whether or not it has been processed) as an important step toward simplified and realistic area price regulation. It is apparent, on this record, that no realistic cost of oil-well gas either as casinghead gas or residue gas can be established and that the various apportionments of the joint costs of gas and oil, or gas and liquids, do not yield results which may be accepted as reliable guides. The evidence in this case and the practical administration of area prices dictates that casinghead gas, residue gas derived therefrom, and old gas-well gas, should be similarly priced. Unlike new gas-well gas, there is no basis on this record for differentiation because of the incentive effect, or otherwise.

The examiner would provide separate ceiling prices for old residue gas and new residue gas. We do not believe such a complication of the area pricing structure is necessary or desirable. We have already made clear that the higher ceiling price for new gas-well gas will apply in the case of residue gas derived therefrom. However, over 96 percent of the residue gas produced in the Permian Basin is derived from oil wells, not gas wells. It results from the search for oil, which will not be stimulated appreciably by a higher price for gas. There is thus little to be expected in the way of increased gas supplies from providing a higher price for such residue gas. All residue gas derived from oil-well gas, therefore, will be subject to the same ceiling price as old gas-well gas.

As stated above, we adopt the presiding examiner's finding that residue gas derived from new gas-well gas is to be subject to the new gas-well gas ceiling. If this were not the case, producers of new gas-well gas would be deterred from selling such gas to a processor from whom they were unable to obtain new gas-well gas prices. With equal prices, gas-well gas will be sold to a processing

plant whenever the sum received for the liquids exceeds the cost of processing. This is as it should be for it would be contrary both to good conservation practice and good economics for price regulation to interfere with the normal operation of market forces where these forces tend to provide the greatest possible benefits to the economy as a whole.

Hunt urges that residue gas must be priced higher than gas-well gas so that a processor selling residue gas can cover his processing costs plus a return on his investment in addition to the price of the gas-well gas he purchases. This reasoning ignores the fact that saleable liquid hydrocarbons are derived from the gas that is processed. The principal purpose of such processing is the removal of these liquids so that revenue may be realized from them. There is every reason to believe that the value of the liquids will be sufficient to justify gasoline plant processing of new gas-well gas. If not, there is no apparent economic reason to encourage the processing at gasoline plants.

We therefore reject the argument that the price of residue gas derived from gas-well gas should exceed that of gas-well gas. For the future, if processors of gas-well gas cannot buy gas-well gas at a price which enables them to make a profit on their operations at the ceiling prices we prescribe, we assume that such gas will not be processed by the producers. As to presently existing contracts by processors for the purchase of gas-well gas, if proper price relationships cannot be negotiated relief may be afforded in a proper case under the special relief provisions set forth later in this opinion. There should be very few of such cases, in view of the extremely small percentage of residue gas derived from gas-well gas.

The Rate for Flowing Gas[31]

Basic Approach

In the previous section we explained why a separate ceiling is not appropriate for casinghead gas or for residue gas derived therefrom and why the cost of old gas-well gas may appropriately constitute the basic yardstick for establishing a single ceiling price applicable to all gas

[31] The term flowing gas in this section will be used to include all gas other than new gas-well gas or residue gas derived therefrom. It includes old gas-well gas, all casinghead gas, and residue derived from old gas-well gas or casinghead gas.

other than new gas-well gas. We proceed with a determination of the cost of old gas-well gas.

The examiner determined the cost of old gas-well gas by employing virtually the same method he used to establish the price of new gas-well gas, with certain cost components adjusted by trending to approximate cost levels in the prior years when the old gas-well gas entered the interstate market. The State of California and the Public Utilities Commission of California have urged that the historical composite cost-of-service for the Permian Basin area based on questionnaire data be used to determine the price of old gas-well gas. Staff's basic case consisted of a composite historical cost-of-service presentation which California Distributors and Staff in its reply brief suggest should be used as a check on the examiner's method of computation of the cost of old gas-well gas.

As we have previously found, the examiner's method which is designed to approximate needed expenditures for finding and producing future gas-well gas supplies is the proper one for fixing the price of new gas-well gas. However, flowing gas is in a different category. Changes in the price cannot increase substantially the total amounts of gas which are already dedicated to interstate commerce[32] nor can they materially affect the supply of oil-well gas which is discovered as a by-product of the search for oil, although they could to some extent affect

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[32] To a small extent the price might affect the stage at which wells are abandoned because the proceeds of operation do not defray out-of-pocket costs.

the amount dedicated to interstate commerce in the future. The revenues received from flowing gas, should, therefore, be based on composite historical costs, including a fair allowance for expenditures for E & D. The price for flowing gas must also reflect the producers' need for revenues from their present sales to support future discoveries.

We believe that the most solid basis in the record for determining the just and reasonable price of old gas-well gas is the composite cost-of-service presentation for the Permian Basin made by the Commission's Staff. The presentation uses 1960 as a test year to determine the cost of old gas-well gas. An approach based on historical costs for flowing gas enables us to draw on the cost finding techniques applied in previous producer cases on an individual company basis. We shall, therefore, use the composite historical cost-of-service for old gas-well gas, for the 1960 test year, as the basis for the flowing gas price. While we place primary reliance on Staff's cost-of-service presentation, we shall later show that the examiner's method of trending back the new gas-well gas cost yields approximately the same cost and thus serves as a useful verification of our result.

It should be noted that we are utilizing a different cost-finding approach for flowing gas than that used in calculating the cost of new gas-well gas. The cost of new gas-well gas was geared to the cost of finding and

producing future gas supplies and as such was built up primarily from nationally published statistics and the questionnaire data which to a large extent identified costs that could be related to gas-well gas. We were thereby enabled to minimize the need for allocations. However, with regard to flowing gas our touchstone is the historical cost of the gas being produced in the Permian Basin in 1960. The primary data includes joint product lease costs and joint E & D expenditures, whereas for new gas-well gas the parties developed cost-finding techniques that minimized the allocation problems. In deriving the cost of the flowing gas-well gas, therefore, it is necessary to utilize allocations to a greater degree than for new gas-well gas (although to a much less extent than with casinghead gas) and for this reason the details of the cost computations of new gas and flowing gas will not be comparable.

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The basic evidence utilized in Staff's composite cost presentation was collected for 1960. In addition, certain trend information was obtained for prior years. These and related data reveal that the 1960 level of costs is fairly representative of the costs during the three year period ending in 1960. While unit costs were somewhat lower in the earlier years, they leveled off in 1958 and so far as the evidence shows have never since exceeded this level. The 1960 test year is, therefore, typical of current and future costs of the flowing gas and it is also

more than fair to the producers as a basis for just and reasonable prices for the prior years when costs were slightly lower. The alternative of a separate cost study for each of the years prior to 1960 would have presented an almost impossible task. At best it would have prolonged this proceeding greatly. Such an effort was not justified since little gas was selling in the 1954-1957 period at prices even approaching our ceiling as established herein.

Preliminary Questions

An initial question in using the composite cost-of-service approach for determining the rate for flowing gas is whether production costs should be determined on the basis of nationwide costs incurred by the producers operating in the Permian Basin or whether their Permian costs alone should be used. While the staff presented its evidence derived from the questionnaires to show costs both ways, it argued that the emphasis should be on the Permian Basin cost experience. The producers, on the other hand, argue that the nationwide basis should be used.

Other than for E&D, the data is available in the record to determine the costs incurred in the Permian Basin. The ceiling price we fix herein is an area rate for flowing gas in the Permian Basin, not a national price, and in our opinion should be based primarily on area costs.

The Major Producer Group argues that if area costs are used the demand for gas would tend to concentrate in the lower cost and lower priced areas at the same time that the lower

prices would tend to discourage exploration and restrict supply in the area. This argument, if valid at all, would apply only to new gas-well gas where the price we fix could materially affect future discoveries, and there we rely on national data. We are here determining costs and rates for flowing gas in the Permian Basin and for such gas we shall, therefore, use Permian costs to the extent feasible.

While the principle is important the issue is not a major one in this area because the difference between national and area production costs is approximately 0.25 cents per Mcf in Staff's presentation.

A further preliminary question arises as to the use of the questionnaire data from Appendix C, the simplified form designed for producers with less than 10,000,000 Mcf of annual jurisdictional sales in 1960. The Commission's Appendix B is a comprehensive questionnaire designed for the major producers, those with 1960 jurisdictional sales in excess of 10,000,000 Mcf. Replies to the major questionnaire (Appendix B) were received in complete form from 67 respondents in the area. These respondents included 42 major producers[33] and 25 producers of less than 10,000,000 Mcf who voluntarily com-

[33] This total includes all the major producers in the area, except one who did not fill out the questionnaire in a usable manner, although given ample opportunity to do so.

pleted the form.[34] Appendix C questionnaires were mailed to all of the over 350 small producers in the area but responses were filed by only 105 of them. Of these only 60 were sufficiently complete to be compiled. The Commission's staff computed the results of the responses to Appendix C separately but included the Appendix C data in its composite cost of service.

The examiner concluded that the data provided by the major producers with respect to their Permian production was fully representative of area costs, but that the response from the small producers in the Appendix C group could not be used because the percentage coverage of the small producers was not large nor was the same sample random.

We agree with the reasoning of the examiner. The issue is of a *de minimis* nature in any event because the percentage of gas produced in the Permian Basin by such producers is so small so that the results could not be affected appreciably. The unit cost of gas in this proceeding would be increased by less than 0.07 cents per Mcf even if Appendix C returns were included. In these circumstances we shall rely exclusively on the Appendix B cost data.

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[34] The returns from these 25 producers do not affect the cost computations to an extent that would change the results.

The Composition of Costs

The total costs upon which the price for flowing gas is to be based may be divided into two principal categories: (1) production costs, which include operating expenses and DD&A (depreciation, depletion and amortization), as well as a return on the production investment and (2) exploration and development costs (E & D), which includes an allowance for the expenses incurred in the search for gas. We are not concerned with the gasoline plant costs which the staff considered and treated at some length because, as already explained, in this area we are determining a price based on the cost of gas-well gas which will also apply to residue gas from other than new gas-well gas.

Production Costs

The compilation of the production costs by the staff is essentially the task of compositing by type of lease the items reported by the producers in response to the Commission's questionnaire and allocating the costs between gas and other products. The allocation problems which we shall discuss herein are the principal difficulties, but there are a number of other issues which must be resolved. They include the treatment of combination leases, corporate common costs, reinjected volumes, the development of oil and gas legs for

allocation of production costs, and lease play allowance. These somewhat technical issues are discussed in Appen-

dix C to this opinion. Otherwise the computation of the composite unit costs of production operating expenses, the composite rate base and the allowance for DD&A, simply involve the arithmetic of compiling the appropriate data. The results are shown in the summary at page 85.

Allocation of Production Costs by the Relative Cost Method

There is of course no allocation problem in computing the production costs of dry gas-well gas. However allocations are necessary for the gas from gas condensate reservoirs. In computing the production operating costs for flowing gas-well gas we shall utilize the relative cost method to divide the joint production costs between the liquids and the gas on the gas condensate leases with lease separation.[35] The basic rationale of the relative cost method is that joint production costs should be allocated in relation to the separate production costs of oil and gas. This method is analogous to the procedure used by United States agencies and approved by this Commission to allocate the cost of a multi-purpose hydroelectric dam between power, flood control and other beneficial uses.[36] The cost of the portions of a dam used for more than one purpose is allocated in accordance with

[35] "Lease separation" refers to the separation of condensate liquids from the gas on the leased property, rather than by later processing.

[36] See, for example, order issued March 5, 1965, in Docket No. E-6383, Allocation of Costs, McNary Project, Columbia River Washington-Oregon, and attached Bureau of Power report.

the relative cost of a separate dam or other required facility for each purpose. Here the relative cost of each coproduct, gas and oil, is used as the basis of allocating the cost of producing the two products jointly.

The first step in the relative cost method is to determine the unit cost of oil from leases producing oil only (the "oil leg") and the unit cost of gas from leases producing gas only (the "gas leg"). The unit cost for each of the two separate products is then multiplied by the volumes of liquid and gas produced on the joint production leases. This provides a total relative cost for the liquids and gas produced on such leases and a ratio of gas cost to

total cost. This ratio is then applied to the total cost of the gas condensate leases in order to obtain the unit costs as they apply to the jointly produced gas.

While producer-respondents and the presiding examiner have questioned the use of the relative cost allocation method, it is relatively simple and workable, has been accepted in principle in our electric power work for decades, and has been repeatedly used and approved by the Commission in producer rate cases. *Phillips Petroleum Co.*, 24 FPC 537 (1960), affirmed *sub nom. Wisconsin* v. *F.P.C.*, 303 F. 2d 830 (1961), affirmed 373 U.S. 294 (1963), especially at pages 553 *et seq.*; *Hunt Oil Co., et al.*, 28 FPC 623, 624 (1962). The reasoning which supports the relative cost method of

allocation in computing individual company costs is equally applicable to composite area costs. The detailed application of the method and the arguments against it are dealt with in Appendix C.

Rate of Return

Among the most important issues is the rate of return for flowing gas. We have already discussed in detail the many factors which led us to conclude that a 12 percent return is appropriate. Two of these factors warrant a somewhat different treatment in considering the appropriate return for flowing gas. First, the great bulk of the flowing gas was not found as the result of exploration or development directed toward gas but rather as an incident to the search for oil. In evaluating the risk factor for flowing gas we must therefore consider that there was by no means the same degree of risk knowingly undertaken in finding such gas as in the case of new gas-well gas. On the other hand, much of the flowing gas in the Permian Basin is below pipeline quality and thus will not command the ceiling price prescribed herein and this problem of low quality is more pronounced in flowing gas than in new gas-well gas.

In our judgment these two factors of lesser and greater risk considered together with the other considerations in our previous discussion of rate of return, which apply equally to flowing gas, persuade us that a 12 percent return is appropriate. Also relevant to our conclusion is the fact that revenues from flowing gas are a factor in the

scale of exploration for new gas. Moreover, flowing gas includes new accretions of casinghead gas and residue gas resulting therefrom, the price of which may well determine the extent to which such gas is committed to the interstate market. Accordingly, we shall allow a 12 percent return on flowing gas.

Summary of Production Costs

Employing the relative cost method, making the other necessary determinations as discussed in Appendix C, and using the 12 percent rate of return, we arrive at 9.16 cents per Mcf for production costs, consisting of the following:

Production operating expenses	1.75
Depreciation, depletion and amortization	2.42
Return	4.99
	9.16

Exploration and Development Costs

Exploration and development costs pose a different problem than production costs. E & D covers dry hole expenses, geological and geophysical expenses, lease rentals, cancelled and surrendered lease expenses, and all other costs expended on nonproductive properties in the effort to find gas. Expenditures for E & D are not earmarked for particular producing areas but on the contrary are incurred on a nationwide basis by the major producers, who make these expenditures largely in accor-

dance with prospects for discovery rather than on an area-directed basis. No one disputes the fact that the E & D allowance for flowing gas should be computed on a nationwide basis.

The principal problem is the proper allocation of total E & D expenditures between gas and liquids. The allocation problem is illustrated in our *Phillips* opinion, 24 FPC 537, 555-562 (1960). After closely analyzing many possible allocation approaches the Commission adopted the use of the modified Btu method in the *Phillips* case and reaffirmed it in *Continental Oil Company*, 27 FPC 96, 104 (1962); *Hunt Oil Company*, 28 FPC 623, 624 (1962); and *H. L. Hunt*, 28 FPC 897, 901 (1962).

The modified Btu method of allocation in the *Phillips* case was designed to utilize as a basic standard the relation of the fuel value of gas to the fuel value of oil, but at the same time adjust this relationship to reflect economic trends and the needs of the public for continued exploration and development. Thus the Commission considered not only the ratio of Btu's in a barrel of oil and in an Mcf of gas (about 6 to 1 for *Phillips* production), but also the increasing demand for gas compared to oil, the deeper drilling needed in exploring for gas, the upward trend of gas production, the ratio of the market price of gas to the price of oil, and other matters. Emphasizing that its determination was based on judgment, the Commission determined that an economic

factor of 4 should be applied to the Btu content of oil to allocate *Phillips'* exploration costs. The resulting cost relationship of finding an Mcf of gas to one barrel of oil was then about 1 to 24, rather than 1 to 6 as on a straight Btu basis. The Commission pointed out that the result might well be different in a case, unlike *Phillips*, where rates were being determined for the future.

In the present area proceeding Staff, through Witness Lyon, advocated the general method used in *Phillips*, with certain refinements, the principal one being the use of separate economic factors for gas-well gas and casing-head gas, in place of the single factor provided in *Phillips*. The total national costs were apportioned by the Staff to the lease products on the basis of these factors, the amounts so allocated were divided by the respective national volumes of the lease products to determine national unit allowances, and these unit values were then imputed to the Permian sales.

The respondents proceeded differently. They propose to allocate the expenses of developmental dry holes on the basis of the well drilling intentions of certain producers who were polled, the expenses of exploratory dry holes on the basis of intangible drilling costs associated with successful wells, and remaining exploratory expenses on the basis of successful expenditures for gas reservoir reserves compared to oil reservoirs. For the separation of gas and condensate, respondents would convert the condensate back to vapor and allocate costs on the basis of the relative vapor volumes of the gas and the condensate.

The examiner correctly found the respondents' method unsound because it ignores the economic purpose of the driller. While a barrel of condensate is worth some 20 times the value of an Mcf of gas, under the producer's vapor volumetric method an Mcf of gas would be assigned about the same E & D expenses as a barrel of liquids which vaporizes to about the same volume as an Mcf of gas. We may also note that in the allocation of developmental dry hole costs there was a considerable degree of self-selection in the responses from the polled producers. Expressions of "intention" also involve subjective considerations. The data obtained are not the result of a random sample of all producers on an objective basis and do not offer a reliable foundation for fixing prices.

We have reviewed the evidence in the record on this issue and believe that Staff's general approach to the problem is sound but that the breakdown between gas-well gas and casinghead gas is an unnecessary complication of the allocation procedures.[37] The issue is one of exercising reasonable judgment in allocating the total cost between the coproducts.

The basic staff method has been attacked by both the producers and the examiner as being circuitous, in that

[37] The further breakdown between gas-well gas and casinghead gas would result in only a difference of 0.12 cents in the E & D expense allocated to flowing gas-well gas and involves the use of questionable value differentials.

the existing price of flowing gas-well gas is used as one of the bases for determining what the price of flowing gas-well gas should be. We are now able to remove an element of circuitry from such an allocation by reason of the fact that we have computed a cost of new gas-well gas of 16½ cents per Mcf by an independent cost finding technique. We are thus able to relate the price of oil fixed by the marketplace to a separately established price of gas, to aid us in making these allocations.

The record indicates that the 1960 average price in the field for liquids is $2.90 per barrel which would be related to the 16½ cents per Mcf price of gas which we have established herein. The questionnaire data in this record reveals that the ratio of Btu's in a barrel of liquids to Btu's in an Mcf of gas-well gas is 5.1 to 1. Utilizing this Btu ratio and the independently established

prices previously mentioned we arrive at a value relationship of a Btu of liquids to a Btu of gas-well gas of 3.45 to 1.[38]

There are other factors which must be considered in arriving at the economic factor for determining the appropriate allocations of E & D expenses between gas and oil. One such guide is the fact, established in the record, that the production costs of a Btu of oil are roughly 4½ times

[38] The price ratio of $2.90 per barrel of oil to 16.5 cents per Mcf of gas is 17.6 to 1. This ratio is then divided by the 5.1 to 1.0 Btu ratio to determine the value relationship of 3.45 to 1.

that of a Btu of gas. Another factor to be considered is that the 16½ cents price is one that we have determined to be appropriate for the future for new gas-well gas and that the price of gas moved sharply upward during the 1950's in relation to the price of crude oil. We must also consider that we are determining a cost to be used for fixing prices for flowing gas for the future as well as for the past.

These considerations and the other data from the record relating to the allocation question, lead us to conclude that in allocating total E & D expenses, an economic factor of 3.5 should be applied to the Btu's of crude oil and condensate liquids production as compared with an economic factor of 1.0 for the Btu's of all gas. Allocations on a Btu basis so adjusted in our judgment will give proportionate weight to the costs, prices, quality and other economic relationships of the respective hydrocarbons.

We also believe that these relative weightings should be applied to the national production of hydrocarbons, rather than to the Permian Basin production because E & D is conducted on a national basis.[39]

Applying these factors to the national production, the E & D costs for flowing gas-well gas would be 4.08 cents. The details of the computation are shown in Appendix C, pages 11-12.

[39] There is in this case little difference in the practical result, since the application of these factors to area production rather than to national production would change the results of the cost computation by approximately .01 cent.

Summary of the Cost of Flowing Gas

The cost of old gas-well gas may therefore be summarized in accordance with the evidence presented by Staff and the discussion above as follows:[40]

[40] There is no separate item for royalty payments because costs were computed on the basis of ⅞ of the actual volumes and the royalty payments were thus included as an integral part of the cost-of-service computations.

Production	9.16
Exploration and Development	4.08
Regulatory expense (see p.)	.14
	13.38
State production tax @ 7%	1.01
Total	14.39

COMPARISON WITH EXAMINER'S COMPUTATION OF COST OF OLD GAS-WELL GAS

As we noted at the outset we place primary reliance on the historical test-year cost of service presentation. However, the examiner's method of computing the cost of old gas-well gas, with the revisions we think necessary, serves as a useful check on the results. It yields a cost closely comparable to that derived from the more traditional cost-of-service approach.

The examiner found that the cost of old gas-well gas should be fixed at the average cost of gas-well gas

produced in 1960. Gas produced in 1960 resulted from exploration and development conducted in some cases many years before, and the cost of drilling and equipping wells which produced gas

in 1960 was incurred in years ranging over a span of two decades. Accordingly, the examiner adjusted his exploration and development costs to reflect the lower cost in earlier years.[41]

We think that the procedure used by the examiner to arrive at his old gas-well gas cost is reasonable but that certain items of his computation require revision.

The examiner found that total exploration and development costs for old gas (dry-hole costs, other exploration and development expenses, and allowance for growth) should be 25 percent below the figure of 4.12 cents per Mcf applicable in the case of new gas-well gas.

[41] In view of the impracticability of determining such costs directly, the examiner used the following procedure, outlined in Appendix C to the initial decision: "The purpose of this analysis is to compare the average finding cost of old gas well gas (the gas produced in 1960) with the cost of finding new gas well gas (the reserve additions found in 1960). The general procedure follows these main steps: (1) the total volume of gas well gas produced in 1960 is distributed by estimated year of discovery; (2) the volume associated with each year of discovery is weighted by an index of drilling cost per MCF for that year (1960=100); and (3) the results are totaled and then divided by 1960 production, thereby deriving a weighted average finding cost for the gas produced in 1960 relative to the finding cost of gas well gas found in 1960. The basic data for this analysis consists of: (1) production of gas well gas reserves; (2) estimates of annual additions to gas reserves; and (3) indices of annual drilling costs per Mcf of reserves added."

This discount yielded a figure of 3.09 cents per Mcf for exploration and development. Production investment costs, DD&A and return, were similarly discounted 25 percent from the 3.95 cents and the 5.21 cents, respectively, applicable in the case of new gas-well gas, yielding a DD&A of 2.96 cents per Mcf and a production investment return of 3.91 cents per Mcf applicable to old gas-well gas.

Unlike production investment costs, exploration and development costs are not capitalized in our decision in this proceeding. They are expenses to be recouped by a producer in the year in which they are incurred. The fact that a lower original investment was necessary to

produce gas flowing in 1960 does not affect the exploration and development expenses incurred in that year. Accordingly, these costs should not be discounted, but should be the same as those included in the computation of the cost of new gas-well gas. We shall therefore allow the same amount for E & D as we permitted in the price of new gas-well gas.

In computing the production investment for old gas-well gas staff contends that it should be 84 percent of the new gas-well gas investment cost rather than 75 percent as a result of two revisions of the examiner's method. Staff accepted the examiner's method of deriving the cost of flowing gas-well gas; however, it proposed an 84 percent rather than a 75 percent discount factor as a result of two revisions of the examiner's method.

Staff's first revision of the examiner's approach was a technical adjustment of the annual index of drilling and equipping costs per Mcf added. The examiner's index measures the trend of the allocated cost of total gas reserves added (gas-well gas and oil-well gas), whereas Staff's index measured a trend of unallocated gas-well costs per Mcf of gas-well gas only reserves added. Since we are deriving a gas-well gas cost it appears that Staff's index is preferable to the examiner's index. Staff has utilized an index which produces a result approximately the same as the examiner's but avoids many of the complicated allocations. Accordingly, we will use Staff's index of drilling and equipping costs.

Staff's second revision of the examiner's backtrend method was to apply its national drilling and equipping cost trend to the vintage mix of jurisdictional gas-well gas produced in the Permian Basin rather than applying the cost trend to the vintage mix of all flowing gas-well gas on a nationwide basis, as was done by the examiner. We have determined that the ceiling price for flowing gas-well gas should be fixed primarily on historical costs in the area (*supra*, 78-79, 80-81). Therefore, the gas-well gas cost trend should be applied to the vintages of gas-well gas in the area.

These adjustments result in a figure of 3.32 cents for DD&A and 4.38 cents for return on production investment rather than the 2.96 cents and 3.91 cents, respectively, used by the examiner.

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With respect to all other items we shall follow the examiner's technique and use the same items of cost as used in the new gas-well gas computation. With respect to the amount for net liquid credit a word of explanation may be in order. The Commission concluded that the net liquid credit should be 3.10 cents per Mcf, rather than 2.68 cents per Mcf as allowed by the examiner. The Commission based its determination primarily on questionnaire data but in our discussion we pointed to the trend in recent years toward increased realization of condensate per Mcf of gas. The trend for the future has limited application to the liquid credit for flowing gas, but we do not rely on this factor and it is not material to our conclusion. The liquid credit we used for new gas-well gas is primarily based upon the questionnaire data which reflects the historical experience of condensate production. The figure we adopted is lower than the amount that could be justified by the latest statistics showing condensate production from the recent discoveries, especially those at greater depths. We believe that our allowance for liquid credit conservatively reflects the condensate derived from the flowing gas-well gas the costs of which we are attempting to verify.

The examiner's computation of the cost of old gas-well gas and our modification of his computation of course reflect the net differences in numerous other items previously discussed in our determination of a new gas-well gas price. A complete comparative summary follows.

	Cost in Cents per Mcf	
	Examiner	Commission
Exploration and Development Costs		
Dry Holes	1.07	1.42
Other Exploratory Costs	1.19	1.59
Allowance for Growth	.83	1.11
Production Operating Expense	2.88	2.70
Net Liquid Credit	(2.68)	(3.10)
Regulatory Expense	.14	.14
Depletion, Depreciation, and Amortization of Production Investment Costs		
Successful Well Costs	2.16	2.42
Lease Acquisition Costs	.57	.64
Cost of Other Production Facilities	.23	.26
Return on Production Investment (at 12%)	3.91	4.38
Return on Working Capital	.20	.35
Subtotal	10.50	11.91
Royalty at 12½%	1.60	1.83
Production Taxes[42]	.72	.90
Total	12.82	14.64

[42] Texas production taxes of 7 percent have been used in this computation. New Mexico taxes are lower, and both cost computations and the ceiling price should be reduced accordingly for gas produced in New Mexico. The amount of production taxes does not include taxes on the royalty payments which are chargeable to the royalty owner. The results however are identical to the alternative method summarized at page 89 in which royalty payments were computed as an integral part of the cost of service and the separate item for production taxes was somewhat higher because it included taxes chargeable to the royalty owner.

It is apparent that the results obtained by using the examiner's method, as adjusted in the light of the Commission's views on liquid credit, return and other items, conform very closely with the results obtained in the Commission's own historical cost computation.

THE PRICE OF FLOWING GAS

On the basis of an historical cost determination, as verified by the examiner's approach, we shall fix a ceiling price for flowing gas rounded off at 14.5 cents per Mcf at 14.65 psia for gas produced and sold in Texas. The ceiling price in Texas includes a 1.01 cent production tax, which we round off to 1.0 cent, leaving a rate less production taxes of 13.5 cents. For gas produced and sold in the three New Mexico counties, Chavez, Lea and Eddy, the ceiling price shall therefore be 13.5 cents per Mcf at 14.65 psia plus the applicable production taxes in effect as of the date of this opinion. In accordance with the earlier discussion, this ceiling price will apply to all casinghead gas, and residue derived therefrom, both old and new, as well as to old gas-well gas and residue gas derived therefrom.

PRICE ADJUSTMENTS TO REFLECT QUALITY DIFFERENTIALS

The importance of quality standards as an integral part of our ceiling price becomes readily apparent if it is recognized that gas is purchased for its energy. The

price of gas cannot be related to volume alone but must be related to units of energy free of impurities and sufficiently compressed to enter the pipeline if it is to serve as a mechanism to assure just and reasonable rates. The presiding examiner pointed up the importance of relating the quality of gas to its price as follows:

> * * * Lowering the quality of the gas is the same as raising its price. If the pipeline purchases gas of lesser quality than previously, bears the cost of additional processing to raise the gas to its former standard, and includes the added costs in its cost of service, the result is the same as if the prices charged for the gas by the producer were raised. A pricing system that fails to insure quality and value is a sieve. [p. 67]

Some of the respondents have urged that no specific price differentials be established to reflect variations in quality. They argue that buyer and seller, after a ceiling price is fixed, will establish lower prices for gas of below standard quality by bargaining.

If we accepted the producers' contention, the burden of securing lower prices to reflect lower quality gas would be on the pipeline, and the record does not support the producers' contention that through bargaining the parties would necessarily agree upon prices for gas with quality deficiencies which were below the ceilings imposed for pipeline quality gas. A large loophole for evasion of

ceiling prices would lie open; a producer receiving the ceiling price for inferior quality gas would be piercing the ceiling prices, insofar as the consuming public is concerned, just as much as if the producer were collecting

an above-ceiling price for pipeline quality gas or deliberately diluting the gas with inert material. In addition, gas now flowing under existing contracts would not be repriced, whatever bargains might be made for the future. Its price would be governed by the existing contract terms, limited only by the applicable area price ceilings. We think, therefore, that in this proceeding we must require the area ceiling prices for new gas-well gas as well as flowing gas to be adjusted for departures from the standards for gas of pipeline quality. We believe that the record in this case provides an ample basis for the quality guidelines we here establish.

A preliminary question is the basis upon which the quality adjustments should be applied. We think these price differences should be predicated upon differences in the quality of gas sold under particular contracts rather than upon an averaging process. Such an approach is fairer to the individual producers, and avoids the possibilities of manipulation which would be inherent in a price system which failed to reflect quality differences in particular transactions.

Quality Standards

The first step in establishing price variations corresponding to variations in the quality of gas is to determine the quality standards which must be met if gas is to command the ceiling price applicable to its particular category. There are several quality factors which require consideration in establishing prices in the Permian Basin and we shall discuss each of them separately.

Sulphur

Sulphur, hydrogen sulphide, and other sulphur compounds are the most prevalent impurities in gas in the Permian Basin. The problem is greater here than in any other area in the country. The generally accepted standard in the Permian Basin, which we here adopt is that gas

which contains more than 10 grains of hydrogen sulphide or 200 grains of total sulphur per Mcf is designated as "sour gas" and is not considered to be of pipeline quality.[43] Gas containing 10 or less grains of hydrogen sulphide and 200 or less grains of total sulphur is known as "sweet gas" and is considered to be of acceptable pipeline quality in this respect. These standards are not only generally accepted in the Permian Basin, but it does not

[43] Total sulphur shall be determined as provided in: "Test for Total Sulphur in Fuel Gases" ASTM Designation: D 1072-56, adopted 1956.

appear that any different standard with respect to sweet and sour gas is applied in other areas.[44]

Water

The record establishes that an accepted standard for pipeline quality gas in the Permian Basin is that the gas shall not contain in the aggregate more than 0.009 pound per Mcf of water, either in the form of liquid or vapor.[45] The prevailing national standard appears to be that gas should contain no more than 0.007 pound of water per Mcf of gas. Even more stringent standards appear in some of the contracts for sale of gas in the Permian Basin.

It may be argued that, since the national average cost has been used in arriving at the ceiling price for new gas-well gas fixed in this proceeding, the national standard for such gas should apply rather than an area standard. Until such time as this Commission has by rule established a different standard, we prefer to adhere to the accepted practices of the industry in the area and we shall consider gas in the Permian Basin containing not more than 0.009 pound of water per Mcf to be of pipeline quality.

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[44] We are cognizant of the slightly more liberal definition of sweet gas used by the State of Texas.

[45] Water vapor content is to be determined as provided in: "Test for Water Vapor Content of Gaseous Fuels By Measurement of Dew-Point Temperature" ASTM Designation: D 1142-58, adopted 1953, revised 1958.

Carbon Dioxide

Carbon dioxide is found in excessive quantities, sometimes as much as half of total volume, in 2 to 3 percent of the gas produced in the Permian Basin. It is not combustible and so has no value as fuel. Under the present technology, it contributes nothing in the way of liquids and is valueless to the petrochemical industry. It is not merely a diluent which reduces the value of the gas in proportion to the extent that it is present; it combines with H_2O to form a comparatively mild acid which has a corrosive effect on pipelines. When present in large quantities, its removal is required before the remaining gas can be considered to be of standard pipeline quality, and extraction may be costly.

The evidence in the record indicates that where carbon dioxide is a problem in the Permian Basin, it comprises over 5 percent of the volume of the gas. However any amount of carbon dioxide reduces the value of the gas and we believe that the presence of more than 3 percent of useless diluent in the gas sold to a pipeline would require a reduction in the price. Accordingly, for the purpose of this proceeding, a standard for pipeline quality gas shall be that carbon dioxide shall not exceed 3 percent by volume.

Other Impurities

There was no testimony in the record with respect to impurities other than carbon dioxide, water, sulphur,

hydrogen sulphide, and other sulphur compounds. Some filed contracts contain clauses requiring the gas sold under them to be free of oxygen, dust, dirt, gums, and other substances. Precise standards cannot be established with respect to these impurities. The only standard which may fairly be applied, on the basis of this record, is that such impurities will be considered excessive to the point requiring a reduction in the price of the gas if they are present in sufficient amounts so that a pipeline incurs processing costs to remove them from the gas.

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Btu Content

The record in this case reveals that in the past the level of Btu content (other than loss of Btu's resulting from excessive carbon dioxide content) has not been a substantial problem in the Permian Basin. Contracts for sales of gas in the Permian Basin generally contain clauses specifying that the Btu content of the gas sold shall not be less than a minimum, generally 1,000 Btu's, and little gas below that level (other than gas containing substantial amounts of carbon dioxide) has been sold in the Permian Basin. Any attempts to evade the ceiling prices for flowing gas imposed herein by reducing the Btu content of the gas below current standards in the area will come to our attention and many be dealt with as the occasion demands. Under these circumstances we see no need to establish any standard Btu

content for flowing gas in the Permian Basin so long as present conditions continue.

Looking to the future, however, we believe that it is important that we implement the general principle that Btu adjustment provisions "are in the public interest", advanced in our recent decision in Texaco, Inc., Opinion No. 464 (decided June 10, 1965). While Btu adjustments have not played a major role in the Permian Basin in the past we believe it important that our price for new gas-well gas reflect the energy content of the gas, which in reality is what the consumer is purchasing. We therefore believe it is necessary and appropriate to provide an upward adjustment for this premium quality feature of benefit to the consumers as well as to provide downward adjustments for deficiencies in quality for new gas-well gas. Such adjustments are to be used in computing the applicable price for new gas-well gas irrespective of whether the underlying contracts contain a Btu adjustment clause. However a producer will of course be limited by his contract if it is below the applicable ceiling as adjusted.

We believe the weighted average Btu content of gas-well gas in the area should generally be used as the guideline for upward adjustments. The weighted average Btu content for gas-well gas in the Permian Basin as shown in Exhibit 118 is 1,042 Btu's per cubic foot. That exhibit reflects the facts for over half of the gas-well gas in the area, and while the precise figure may be somewhat higher

or lower, the exhibit indicates that the weighted average is certainly well above 1,000 Btu's per cubic foot and does not exceed 1,050 Btu's. Accordingly, in computing the quality adjustments to the ceiling prices for new gas-well gas we shall permit an upward Btu price adjustment from a base of 1,050 Btu's per cubic foot on a proportional basis above the ceiling price fixed herein. The record also reveals that a minimum standard for pipeline quality gas in the Permian Basin is 1,000 Btu's per cubic foot. The 1,000 Btu minimum is not a national standard but is based on the evidence of the practice in the Permian Basin. We shall accordingly provide a downward adjustment for new gas-well gas from a base of 1,000 Btu's on a proportional basis from the ceiling price fixed herein.[46] The range of 1,000 to 1,050 Btu in which no adjustment will be required in the Permian Basin is not necessarily controlling for other areas where the record may well suggest a narrower range.

The Btu content of the gas to be used in determining price adjustments can be defined as the total heat value of the standard cubic foot as specified in Opinion No. 464. So that no producer will be penalized twice by the application of a reduction in rate for Btu deficiency in addition to a reduction required by the presence of carbon dioxide or other impurities, the Btu content should be measured after any necessary processing of the gas to remove impurities, as well as after removal of any liquids

[46] For example, new gas-well gas containing 1,155 Btu's will be allowed a 10 percent increase in rate, and new gas-well gas containing 950 Btu's will be subjected to a 5 percent reduction in rate.

for which the buyer pays separately, whether on a percentage basis or otherwise.

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Pressure

The question of pressure is more complex. Gas cannot enter a pipeline unless it is under greater pressure than the pipeline pressure at the point of entry. Gas of lower pressure must be compressed to raise its pressure above that of the pipeline which it is entering. It is not the number of pounds by which a given quantity of gas may fall over pipeline pressure that is important, but the number of stages of compression through which the gas must be put in order to raise its pressure sufficiently. The majority of the main-line pipelines in the continental United States operate to maintain a pressure at the compression stations ranging from 800 pounds to 1,000 pounds per square inch (psi) or about 900 psi on the average. Evidence in this case of actual delivery pressures for producers in the Permian Basin indicates that pipeline purchasers in the Permian area have main-line operating pressures averaging about 800 psi. Thus we are presented with the question of whether a national pressure standard of some 900 psi should be adopted here or whether we should use the average pressure in the Permian Basin of about 800 psi.

It could be argued that where national average cost is used in establishing a ceiling price, the average national pressure should also be used in establishing the standards

to which gas priced at the ceiling must conform. However, the prices we fix here are area prices, and may be modified in other areas for factors other than cost. The adoption of a 900 pound pressure standard for the Permian Basin would require a price reduction on all Permian Basin residue gas and nearly all gas-well gas. While delivery of gas at higher pressure would confer some benefits on the pipeline (by reducing the amount of compression needed to move gas along the pipeline) it seems inequitable to penalize the producers and processors who deliver gas at the pressure for which the pipeline is designed and who in many cases could have delivered it at higher pressure if called upon to do so, without additional expense. The physical equipment in the Permian Basin is now largely geared to delivery at 800 pounds pressure. We shall therefore adopt an 800 pound pressure standard for the Permian Basin.

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The Amount of Price Adjustment

In accordance with the foregoing, we set forth the following principles to govern price adjustments when a purchaser buys gas which deviates from the standards here established for gas of pipeline quality:

(1) The applicable ceiling price shall be adjusted downward by the net cost of processing the gas to bring it up to standard, by the amount of any applicable upward or downward Btu adjustment (for new gas-well gas only) and by the amount of any sav-

ing or additional expense to the seller from any reduction or increase in taxes or royalty payments resulting therefrom.

(2) If the processing is performed by the purchaser, a reasonable return upon the required investment should be included as a part of the processing cost incurred in bringing the gas up to pipeline quality.

(3) If processing reduces the volume of the gas, the purchaser shall pay for only the volume remaining after processing.

Procedure

In establishing a procedure for determining the amount of the reduction in the ceiling price applicable in the case of gas with quality deficiencies, our purpose is to impose the minimum regulatory controls required to carry out effectively our responsibilities to assure wholesale customers that the price they pay will be just and reasonable. Accordingly, sales by small producers that are covered by the proposed small producer certificate rule, shall be exempt from such adjustments on the *de minimis* principle, because the burden and expense involved would in most cases exceed the amount of the adjustments. Furthermore, the major producers, processors, and pipelines will be allowed in the first instance to establish among themselves, in accordance with the standards set forth here, the amounts by which ceiling prices should be adjusted in the case of each individual contract which deals with gas which deviates from the quality standards

herein established. If the parties reach agreement that no change from the ceiling price is required or that a specific price adjustment is required, a statement

of the agreed price for the gas shall be filed no later than 90 days from the effective date of this order. The producer as part of the statement shall itemize the amounts and nature of each of the quality adjustments and explain the basis therefor, and set forth the price agreed upon by the parties as representing the applicable ceiling price as adjusted.

If the parties are unable to agree upon any or all of the quality variations of the gas or the costs of remedying defects (except for sales by small producers exempt from these quality adjustments), the required statement must so indicate and the seller must supply the itemized information required to compute the applicable ceiling price as adjusted. The buyer will be given an opportunity to state its position and the Commission will then determine the applicable area rate. Pending such determination, the seller may collect a price not in excess of the unadjusted area ceiling price for the type of gas in question, subject to the obligation to make refund of any excess collected, from the effective date of this order, above the applicable area rate (the ceiling rate reduced by the cost of processing to correct quality deficiencies and, in the case of new gas-well gas, further adjusted for Btu variations) ultimately determined to be proper.

No pipeline will be entitled, as part of its cost of service, to any amounts paid for gas in excess of the applicable ceiling price as adjusted in accordance with the standards and principles set forth in this opinion. The acceptance for filing of any amendment or certificate, or the failure to suspend any rate so established, shall not prevent the application of this rule.

It is our expectation that this procedure will result in the parties determining the proper adjustments in price levels to reflect differences in the quality of gas sold. Should this objective not be realized and should the Commission be confronted with a large number of contests, or should it be found that evasion or abuse is prevalent, it may be necessary to take measures to fix the precise price variations corresponding to variations in gas quality.

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PETITIONS FOR SPECIAL EXEMPTION FROM THE AREA RATES

We have already discussed *supra* at pages 11-19 why we believe that maximum area rates can and should be established as the just and reasonable rates applicable generally to the sales of natural gas in the Permian Basin. The question remains what procedure or procedures should be adopted for the benefit of those respondents who, by reason of special circumstances, believe they can demonstrate that they are entitled to variant treatment.

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First, we should frame the limits of the problem. We are not here treating sales to be permanently certificated after the effective date of this decision. In the future it would normally not be in the public interest to certificate sales of gas (including gas flowing under temporary certificates) at initial prices above the applicable area rate. While we do not visualize any reason for certifying any new sales at prices above the just and reasonable ceiling price, any producer unwilling to accept a certificate at the appropriate ceiling will have an opportunity to show in the hearing on his certificate application the special circumstances which he believes warrant making an exception in his case in the public interest.

The problem for our immediate attention thus relates solely to gas presently being sold under outstanding certificates. Our decision herein has a double impact on the gas presently flowing in interstate commerce from producers in the Permian Basin. It fixes a price for the future, and it determines the basis for refunds for past periods. We shall first discuss the basis for permitting special exceptions to the area rate with respect to future rates for flowing gas and later discuss the question of relief from refund requirements.

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It would seem clear that where a producer who has contracted for an above-ceiling price can show that his out-of-pocket expenses in connection with the operation of a particular well are greater than the revenues under

the applicable area price, he should be entitled to appropriate relief, and there may be other circumstances where a producer as a matter of law or in the public interest would be entitled to some relief.

We need not and cannot here specify all of the special circumstances which may serve as a basis for exceptions to the area rate. It is clear however that confiscation does not result merely because, as a result of high costs or low production, a given producer cannot, at the area price, recover his expenses for his unsuccessful exploration and development costs and earn the 12 percent overall return on producer investment rate base which we have adopted as the appropriate return to attract capital on an area-wide basis for gas exploration and development. We recognize that any amounts received by the producer for flowing gas above out-of-pocket expenses would be available to finance further exploration, but no producer has a constitutional right to a price for the future which will enable him to expand his venture in the interstate gas business and the inability to earn such allowances at the area ceiling cannot be characterized as confiscation. As the Court of Appeals for the District of Columbia recently observed, "the Commission is not required to subsidize high cost producers with consumers' money." *Atlantic Refining Co.* v. *F.P.C.*, 316 F.2d 677, 680 (CADC, 1963); see also *Callery Properties, Inc. et al.* v. *F.P.C.* 335 F.2d 1004 (CA5, 1964). The same rule certainly applies to the development of reserves which are held off the market for speculative purposes.

Even in situations where producers are able to show that they are entitled to relief from the obligation to con-

tinue to sell flowing gas at the appropriate area ceiling, in most cases it may be sufficient to permit them to abandon their unprofitable sales. Unlike the case of some public utilities which cannot abandon service without harming the public dependent thereon, we will seldom have a situation in which a particular producer's

abandonment of some or all of its sales in the area will significantly affect the purchasing pipeline, to say nothing of the ultimate gas consumer. There may, however, be some exceptional situations where abandonment could be shown to be detrimental to consumers, or where the producer could demonstrate that some other form of relief would best serve the interests of the public as well as his own.

The remaining confiscation question is with respect to refunds for past periods. On a composite basis the area ceiling prices for both flowing and new gas provide a reasonable allowance for exploration and development and production operating expenses in addition to a 12 percent return on the producing investment. As we stated earlier, a claim that it would be confiscatory to require the refund of amounts a producer has collected above the area rate cannot be supported by the fact that a particular producer in the past has chosen to spend more than a reasonable allowance in what proves to be unsuccessful or marginal exploratory efforts or by the fact that unit production costs are high because for speculative purposes

or other reasons the producer has withheld from production gas that he has discovered. On the other hand it seems clear that a producer should not be required to make refunds for past periods which would deprive him of amounts sufficient to cover his out-of-pocket operating expenses in the Permian Basin for such period. We need not consider other situations at this stage of the proceeding; it is sufficient to note that here too we will entertain petitions for special relief, and that the dockets involved will remain subject to the existing interest obligations pending their resolution.

We need not speculate further here as to the exact circumstances in which special relief may be warranted from the area price maximums for some or all of a producer's sales, or the appropriate nature of such relief. Any producer claiming that he is entitled to special relief from the maximum rate set for any of his Permian sales or from the refund obligations imposed herein may file a petition for such relief with the Commission consistent with the general guidelines set forth herein. Any such petition will be disposed of as promptly as possible.

Since the petitioner will bear the burden of showing that he is entitled to special relief the producer (unless authorization is granted for temporary abandonment) will not be relieved of his obligation to continue service at the appropriate just and reasonable rate pending the determination

of his petition. See *The New England Divisions* case, 261 U.S. 184, 198-199 (1923).

CHANGES IN THE AREA RATE

Our adoption here of a two-price vintaging system of fixing just and reasonable producer prices simplifies questions as to the appropriate or permissible methods for changing such prices. The two-price system enables us to provide a higher price for future discoveries if justified by changed circumstances. It is unlike the situation resulting from the utilization of a single price based upon historical costs, where significant changes in conditions may necessitate a change in the just and reasonable price for all gas. For example, an indication that new well drilling costs were increasing might (all other things being equal) demonstrate that a higher price should be set for gas certificated at some date in the future but would not necessarily show that the just and reasonable price we here prescribe for gas already flowing requires revision. Other changes unrelated to the continuing operations under which flowing gas is brought to market will be relevant only to the question of whether a new price should be set to govern future sales, thus permitting price stability for gas already dedicated to the interstate market.

This does not mean that the just and reasonable price for flowing gas can never vary. We have fixed the price of the pre-1961 gas-well gas and all other gas on the basis of the composite cost showing of gas-well gas for the Permian Basin in 1960. Of course if it could be shown that the average rates of take of such gas had

significantly dropped or that the continuing operating costs of the gas wells had increased significantly, it might well be that the maximum just and reasonable price for such gas should

be adjusted. This would also be true for the gas coming into the market since 1960, although the evidence of record indicates that costs have remained remarkably steady during the ensuing years and are likely to remain stable during the moratorium period prescribed herein. Essentially, under the type of pricing we are instituting, the cost of flowing gas-well gas and all casinghead gas and residue gas derived therefrom will tend to remain relatively constant and permit stable rates, even though changing circumstances might demonstrate the need for new and substantially different rates for gas-well gas coming on to the market at later periods.

In this framework, we approach the question of the appropriate mechanism for altering the area rates. We can, of course, in this proceeding fix the just and reasonable price only for gas flowing pursuant to outstanding certificates. We believe that a moratorium for new rate increase filings above the applicable area ceiling prices for a 2½ year period is essential if our decision herein is to achieve effective control over producer prices. In the absence of such a moratorium the producers would be free to file rate increases and continue to collect their producer prices even though they exceeded the just and

reasonable rates herein prescribed. Without a moratorium, the conclusion of one area proceeding would only signal the beginning of the next, and just and reasonable rates for consumers would always be one area proceeding away.

The Supreme Court recently noted the obvious inadequacies of the refund obligation as a protection of the public interest (*F.P.C.* v. *Tennessee Gas Transmission Co.*, 371 U.S. 145, 154, 155 (1962); *F.P.C.* v. *Hunt*, 376 U.S. 515, 524 (1964)). Without the moratorium we have provided the public interest could be protected only to the extent that the Commission could devise procedures to enable it to complete an area proceeding within the 5-month suspension period or shortly thereafter. See *F.P.C.* v. *Tennessee Gas Transmission Co., supra;* cf. *Panhandle Eastern Pipe Line Co.* v. *F.P.C.*, 236 F. 2d 606 (CA3 1956).

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While the Supreme Court's description of a Section 5 producer rate proceeding in the *Catco* case as "well nigh interminable" is, we hope, no longer apt, the more than four-year history of this case, conducted with acute awareness of the running of time, demonstrates that we are dealing with inherently time-consuming proceedings. We expect to complete future area cases in much less time, but we would be unrealistic in the extreme to assume that any rate proceeding could be completed in less than several times the length of the 5-month suspension period. Without the limited moratorium on rate

filings prescribed by our order herein this mammoth proceeding would fix prices for only a 5-month period and the producers could then overturn the Commission's order by a series of new filings to reinstate their pre-existing rates.

It is our view that the filing of rate increases by a natural gas company pursuant to Sections (d) and (e) can be limited either by private contract or as a result of the reasonable exercise of this Commission's authority under Sections 5, 7 and 16 of the Act. Certainly, it would be an anomalous situation if the filing of rate increases could be restricted by private bargaining but not by reasonable exercise of regulatory authority in the public interest. We have exercised such authority in this initial proceeding fixing rates on a group basis under the Natural Gas Act because it is an essential feature of the area approach if it is to achieve effective control over producer prices for the protection of consumers. We believe the 2½ year period is the minimum time required to afford price stability that will be beneficial to consumers and the industry as well. Considering the evidence of stable costs, and the provisions for earlier relief, if warranted, this limited moratorium is not unfair to producers.

The producers nevertheless contend that pursuant to the provisions of Section 4(d) of the Act, a natural gas company has a right to file any contractually authorized rate increase even if the Commission has just held that the maximum just and reasonable price for such sale is of a lesser amount. They argue that the only procedure available

to the Commission is to enter into the suspension and hearing procedure established by Section 4(d), with the company having the right to put the increase into effect subject to refund at the end of the maximum statutory five months' suspension period.

We do not believe that the Commission's powers are so limited that its regulatory efforts must be futile where after a long and full hearing we have determined the just and reasonable rates to be set for the future. The *Mobile* case (*United Gas Pipe Line Co.* v. *Mobile Gas Service Corp.*, 350 U.S. 332, 339 (1956)) made clear that:

> * * * § 4(d) is simply a prohibition, not a grant of power. It does not purport to say what is effective to change a contract, any more than § 4(c) purports to define what constitutes a "contract" that may be filed with the Commission. The section says only that a change *cannot* be made without the proper notice to the Commission; it does not say under what circumstances a change *can* be made * * * [emphasis in original]

It is true that despite the Court's explanation of the meaning of Section 4(d) as simply a prohibition on filings, and not a grant of power, the opinions of the Court in *Mobile* and in the subsequent *Memphis* case (*United Gas Pipe Line Co.* v. *Memphis Light, Gas & Water Division*, 358 U.S. 103 (1958)), contain dicta to the effect that a pipeline can file for such increases as

are contractually authorized and after the suspension period, put them into effect subject to refund. See also *Atlantic Refining Co.* v. *Public Service Commission of New York* (CATCO), 360 U.S. 378 (1959). These dicta must be read in context of the issue raised in the cases, which was the effect of restrictions on increased rate filings by pipelines stemming from contractual limitations by the parties in circumstances where the pre-existing rate had not been fixed by the Commission pursuant to its authority to prescribe just and reasonable rates for the future. These cases dealt with regulation on an individual company basis in which there is a long administrative

history of permitting increased rate filings and where the Commission as a matter of policy has never written a moratorium into a rate order. They are entirely consistent with our recent order in *United Gas Pipeline Co.*, RP65-1, ... F.P.C. ....., issued October 22, 1964, where in refusing to reject an increased rate filed by a pipeline we made clear that "the Commission is [not] completely without discretion to impose by rule or by order a reasonable moratorium on the filing of rate increases under Section 4(d) of the Act in circumstances where the orderly administration of the Natural Gas Act makes such conditions necessary."

The authority we assert herein is neither novel nor unique as applied to group rates set after full agency hearing. The ICC operating under a statute containing

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language virtually identical to Section 4 of the Natural Gas Act long ago stated that "to say that the Commission's order may be defeated merely by publication and filing of a rate higher than that prescribed by the order is to say also that the shipping public is not entitled to the protection of this Commission's orders during the period they are in force * * * *." (*City of Springfield, Tenn.* v. *Louisville N.R. Co.*, 53 ICC 603, 605, 606 (1919); see *Fifteen Per Cent Case*, 45 ICC 303 (1917).) The CAB has similarly held that a group rate fixed by the Board could only be modified by subsequent Board action and not by a carrier's unilateral filing. *Minimum Rates Applicable to Air Freight* Order No. E-17370, 34 CAB 263 (1961).

The Supreme Court has expressly held in *United States* v. *Corrick*, 298 U.S. 435, 439, 440 (1936), that where the Secretary of Agriculture under the provisions of Section 310 of the Packers & Stockyards Act (7 U.S.C. § 211 (1921)) prescribes "the just and reasonable rate or charge, * * * to be thereafter observed" such rates "become the only lawful rates and so remain until further order of the Secretary" and cannot be altered by the unilateral action of a particular marketing agency pursuant to provisions of Section 306 of the Packers & Stockyards Act (7 U.S.C. § 207). That section is virtually identical with Section 4 of the Natural Gas Act.

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It cannot be argued that the ICC and Packers & Stockyards Acts precedents are not in point because those acts

expressly provide that orders fixing just and reasonable rates "shall continue in force until [the agency's] further order". (see Interstate Commerce Act, § 15(2), 49 U.S.C. § 15(2); (1887); Packers & Stockyards Act, § 313, 7 U.S.C. § 214). The ICC adopted the position noted above before the language in question was introduced into its Act in 1920[47] and the Supreme Court in *Corrick* supported its conclusion not by reference to the different language of Section 313, but by the quoted language of Section 310 which parallels Section 5(a) of the Natural Gas Act and by citing its earlier decision in *Arizona Grocery Co.* v. *Atchison T.&S.F. Ry. Co.*, 284 U.S. 370 (1932), standing for the general proposition that where the agency "declares a specific rate to be the reasonable and lawful rate for the future, it speaks as the legislature and its pronouncement has the force of a statute" (284 U.S. at p. 386).

The absence in the Natural Gas Act of language similar to that found in Section 15(2) of the Interstate Commerce Act and Section 313 of the Packers & Stockyard Act, means only that Commission orders under Section 5(a) do not automatically have the effect of tolling the availability of Section 4 filings (see *United Gas Pipe Line Co., supra*). It leaves the Commission free to exercise its express authority to "fix" by order "the just and reasonable . . . rule, regulation, practice or contract to be thereafter observed and in force" (Section 5(a)) and to "perform any and all acts and to prescribe . . . such

[47] Cf. Section 3 of the Hepburn Act of 1906 (34 Stat. 589) with Section 418 of the Transportation Act of 1920 (41 Stat. 484).

orders, rules and regulations as it may find necessary or appropriate to carry out the provisions of this act" (Section 16); See *Public Service Commission of New York* v. *F.P.C.*, 327 F. 2d 893, 896-897, (CADC, 1964).

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The Commission under Sections 5(a) and 16 of the Natural Gas Act may impose a reasonable moratorium on increased rate filings under Section 4 which are inconsistent with the just and reasonable rates found after hearing, and require that during this period the just and reasonable rates be changed, if at all, solely by modification of its original decision after appropriate proceedings held in that docket. The orderly administration of the Natural Gas Act necessitates that we exercise such authority in fixing the rates for sales by gas producers on an area basis.

It will therefore be our policy to certificate new sales of gas in the future at initial prices no higher than the just and reasonable price for new gas, and upon condition that no increased rate higher than the ceiling price be filed before January 1, 1968 (a 2½-year period which we believe to be the reasonable duration for a moratorium on filings for rates higher than the ceiling prices fixed on the basis of this record), unless within such time, either upon the Commission's own motion or upon an adequately supported petition by some interested party, the Commission at its discretion decides to reopen this proceeding to consider whether a different rate or

rates should be adopted for sales certificated at subsequent periods. We expect that the just and reasonable rate for new gas would constitute the maximum price at which new gas would be initially certified, the so-called "in-line" price, until the just and reasonable rate is changed by the Commission.

As to existing sales, whether they fall within the categories to which the flowing gas or new gas-well gas rates are applicable, we shall, pursuant to our authority under Sections 5 and 16 of the Act, similarly provide against any filing of rate increases above the applicable ceiling price fixed herein before January 1, 1968, but will permit any interested party within such period to file a petition directed to the Commission's discretion, showing why it believes the proceedings should be reopened to consider earlier changes. The Commission reserves the right to reopen the proceeding in its discretion to permit earlier changes in rates in the event of drastically changed circumstances. In any event after the 2½-year period, we shall also permit contractually authorized rate increase filings to be made pursuant to Section 4 for all sales in the area.

MINIMUM RATES

The examiner found that certain contracts in the Permian Basin were "below the revenue standards" he adopted. While the record is not clear on this point many of these contracts presumably were negotiated at a time

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when natural gas was a by-product of the search for oil and the interstate markets had not yet developed.

To aid in rectifying the situations where producers had contractually precluded themselves from obtaining an increase in price of their gas, the examiner authorized the seller, with the consent of his buyer, to increase his rates up to the minimum established in the decision; to wit, 9 cents per Mcf of gas-well gas and 7 cents per Mcf for casinghead gas.

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The Supreme Court in *F.P.C.* v. *Sierra Pacific Power Co.*, 350 U.S. 348 (1956),[48] recognized that this Commission possesses the power to authorize rate increases despite contractual limitations to the contrary. However, the Court was careful to point out that such an order required as a foundation more than the mere fact that, because of an improvident bargain, a utility was receiving less than a fair price for its product. The Court said (at p. 355): "In such circumstances the sole concern of the Commission would seem to be whether the rate is so low as to adversely affect the public interest — as where it might impair the financial ability of the public utility to continue its service, cast upon other consumers an excessive burden, or be unduly discriminatory."

[48] Though this case involved the Federal Power Act, the Court noted that: "The pertinent provisions of the Federal Power Act, * * * are §§ 205(c), (d), and (e), and 206(a), which are substantially identical to §§ 4(c), (d), and (e), and 5(a), respectively, of the Natural Gas Act." (at pp. 350-351)

It is thus clear that the test of whether rates should be increased is not one of private equities but of the public interest. It is also clear that the examples set forth by the Court are not, and were not intended to be, the only instances where public interest would justify an authorization to increase rates in contravention of a contract. In addition it should be noted that the *Sierra* case was decided in the context of an individual company rather than an area rate approach.

We concur with the examiner in his conclusion that the establishment of minimum rates in this case is in the public interest and that the price impact on the consumer will be *de minimis*. While on the other hand, the establishment of a maximum price for the area is essential so that the ultimate consumer does not pay a price which is excessive in relation to group costs and other relevant considerations, we believe that a minimum price also

constitutes an integral part of the area rate approach. The rate received by a producer must not be so low as to prevent or retard further exploration and thereby decrease possible discovery of gas reserves which will be needed by consumers. The amount of additional revenue so provided, at the most $250,000 annually, will have no significant impact on consumers but the relief afforded the individual producers involved may be important to their continuation in the search for additional gas sup-

plies needed to meet the growing needs of the consuming markets.

Although we have agreed with the examiner's conclusion as to the need for a minimum rate, we believe that his remedy, which would not allow the producer with sub-minimum rates to raise them to the minimum unless he secured the approval of his purchaser, is not sufficient. Renegotiation of contracts resulting in increased rates which do not exceed the area rate would be proper without any action by this Commission, so that the examiner's remedy would avail nothing.

We therefore deem it necessary and appropriate to establish a minimum rate in this area of 9 cents per Mcf for gas of standard pipeline quality, with adjustments from the minimum price to reflect any deviations from the quality standards established herein, and to hold that the minimum rate herein established may be filed without purchaser approval at any time after this order becomes final.

REFUNDS

We shall require appropriate refunds in the case of rates which are the subject of proceedings under Section 4(e) of the Act, and have thus been collected subject to an obligation to refund amounts collected in excess of the just and reasonable rates as here determined. In each case the proper rate level for computing refunds shall be the area rate applicable to the particular category of gas involved, as adjusted by reason of any quality deviations in the particular gas.

The presiding examiner proposed that the total refunds to be made with respect to contracts for the sale of gas-well gas should be computed for each separate year on the basis of whether the industry as a whole had collected an excessive amount for gas-well gas in that year. Under this proposal, if one producer collected revenues from the sale of gas-well gas in excess of his proper prices, he would be required to refund such excess amounts only if it were shown that the industry as a whole in that year had received revenues from gas-well gas in the area in excess of the proper revenues for such gas. The same principle would be applied with respect to residue gas and to casinghead gas. Further, any deficiency in any year in overall industry revenues from any one of the three categories — gas-well gas, residue gas, or casinghead gas — would be used to offset excessive revenues collected for any other category of gas.

The underlying theory of the presiding examiner's approach is that refunds should be ordered only to the extent that overall industry revenues exceed overall industry expenditures in a given year. The briefs on exceptions indicate that many of the parties are not clear as to how this theory might be applied in particular cases.

Several fundamental objections preclude adoption of the examiner's proposed method of computing refunds. We think it would result in inequities among wholesale customers as well as among individual producers. If one

wholesale customer has been overcharged it is of little comfort to him to know that another customer has received a bargain. Conversely, if one producer has collected excessive amounts, he should not be relieved of his responsibility to return the excess by reason of the fact that some other producer collected too little. Furthermore, the administrative difficulties involved in attempting for each year, and each category of sales, to equate industry revenues with industry expenditures, and to allocate the excess revenues among the purchasers, seem almost insurmountable.

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We have established just and reasonable ceiling prices for the Permian area, with adjustments from the ceiling prices in the case of gas which deviates from the quality standards we have established. The applicable ceiling price, including any quality adjustments, is the proper price for gas sold under a particular contract. We think it is proper and equitable to require refunds of amounts collected in excess of the ceiling price for gas sold under each contract. This has been our practice in prior proceedings under the Natural Gas Act, and on this record we see no reason, legal or equitable, to fail to return to the wholesale customers the excess sums they have paid. To the extent that any producer receives a lesser amount than our ceilings permit it is because he has agreed to prices which yield that amount or failed to file for a higher rate.

Refunds will be required only with respect to the rates which are the subject of Section 4(e) proceedings, and only for the periods during which such rates have been collected subject to refund.

A refund procedure must be established. We have determined that price adjustments corresponding to departures from standards shall be left to the parties for initial determination, if they are able to agree. The price applicable to particular gas cannot be finally determined until the parties have determined the quality of gas and the computed corresponding price adjustments. Accordingly, each producer (except small producers, who will be considered below) shall file a computation of refunds due with respect to each rate schedule within 30 days from the date of the filing of an agreement with his purchaser as to the quality of the gas sold and the cost per Mcf of processing such gas to pipeline quality standards. If no such agreement is reached the refund computation is to be filed within 30 days from the date of Commission determination of the quality adjustments. (See pp. 102-103 hereof for procedure).

In the case of Section 4(e) proceedings, the refund computation shall also be made for all periods during which rates were collected subject to refund. With regard to each rate schedule, such computation shall specify the applicable rate or rates as established in accordance with the principles set forth in this opinion (including

any adjustments for quality as prescribed herein), the rate or rates collected during the period subject to refund, the period during which any rate was collected in excess of the proper applicable rate, the volume of gas for which such excess rate was collected, and the amount of refunds due. Interest on such refunds (at the prevailing rate) shall be included in the computation.

Each producer will be directed to retain the refunds to be made by him until further order of the Commission. Such retention shall be in accordance with the option principle established by the Commission in *Humble Oil and Refining Company*, 32 FPC 49, Docket Nos. G-9287, *et al.*, issued July 8, 1964.

The rates for small producer sales as defined in the rule providing for small producer certificates for such sales proposed this date are not required to reflect any quality adjustments either for past periods or for the future. Small producer refund obligations will therefore extend only to refunding amounts

collected subject to refund in excess of the amounts collectible under the base ceiling rates. If a small producer wishes to take advantage of any permitted upward adjustment for new gas-well gas of high Btu content, he will be required to indicate also any offsetting deficiencies in quality of the gas in question by filing the same statements required of large producers.

SMALL PRODUCER PROBLEM

There have been many suggestions, foremost of which are those by Justice Clark dissenting in *Wisconsin* v. *F.P.C.*, 373 U.S. 294, 329-30 (1963), and speaking for the Court in *F.P.C.* v. *Hunt*, 376 U.S. 515 (1964), to the effect that this Commission should consider procedures for the exemption of small producers from regulation. There are many compelling arguments to justify distinctive treatment of small producers. The justification goes beyond the obvious benefits of relieving the small producer of the expense and burden of the regulatory process. Among other considerations, expediting the administrative process and facilitating effective regulation are suggested as additional benefits.

The examiner has set forth a well documented argument for recognizing the special problems of the small producer and affording him separate regulatory treatment. At the very heart of his analysis are two basic propositions which serve to distinguish the small producer from the large. The first is simply a recognition of the characteristic of "smallness," which as the examiner has said means that the typical small producer has limited operations and is thus subject to a greater degree of risk than is a large producer.

The examiner's second proposition is that the small producers, although numerous, account for a relatively small share of the natural gas produced in this country, and that

even without regulation they usually cannot obtain more for their gas than the regulated price we fix for the major producers. In the nation there are over 2,000 small producers as defined by the examiner, *i.e.*, those selling less than 10 million Mcf of gas per year, filing rate schedules with this Commission. They provide only about 15 percent of the total supply of natural gas moving in interstate commerce. The examiner concludes that the exclusion of the small producer from direct price control would thus have a *de minimis* impact on the consumer while the effect on the small producer would be highly beneficial. His procedural device for according exemption was a blanket finding that all the rates of the small producers were just and reasonable.

We agree with the examiner in general that special treatment of the small producer group offers scope for streamlining the regulatory process without the risk of substantial impact on consumer prices. Consumers and the natural gas industry alike have a strong stake in the continuation of the exploration efforts of the thousands of small operators, who contribute a large share of the discoveries of new sources of gas. Easing the burdens of regulation would help to assure their continued participation in the gas production business.

While we are convinced that there is need for distinctive treatment for small producers, which we shall provide herein, we do not believe it is necessary or desirable

to provide outright exemption. We reach this conclusion assuming that exemption is legally permissible despite the mandatory language of Sections 4 and 7 of the Natural Gas Act.[49]

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In our opinion the salutary objectives of those who propose exemption can better be achieved within the framework of regulation. Furthermore, any exemption for small producers would be more an illusion than a reality. As the small producers suggest, the area ceilings we prescribe will tend to set the maximum prices they can obtain for their gas.

A basic consideration in reaching our conclusion in this matter is that the impact of small producer prices on consumers is by no means *de minimis* on an area basis, and is of great impact in some situations. Sales by small producers constitute 80 percent of the gas supply of one pipeline[50] and range from 9 percent to about 60 percent

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[49] Section 4(a) states in part that "*all* rates and charges" by "any natural gas company shall be just and reasonable." In Section 4(c) it is stated that "Under such rules and regulations as the Commission may prescribe, *every* natural gas company shall file * * * in such form as the Commission may designate, * * * *all* rates and charges * * *."

Section 7(c) provides in part that "No natural-gas company * * * shall engage in the transportation or sale of natural gas, subject to the jurisdiction of the Commission * * * unless there is in force with respect to such natural gas company a certificate of public convenience and necessity * * *."

[50] Kansas-Colorado Utilities Company, see F.P.C. Form 2.

of the supply of the other 25 largest pipelines. While small producers represent only 15 percent of the aggregate interstate gas supply it is obvious they are a substantial factor in the cost of the gas supply of millions of American consumers.

Another consideration which weighs with us is that penetration of rate ceilings, even on a small scale, could be seriously disruptive of a pattern of uniform area ceilings.

The examiner suggested relief for small producers from present filing requirements in the following manner: (1) a general certificate would issue to those natural gas companies which meet the qualifications of a "small producer", and (2) such producers would be required to file annual statements containing information as to their jurisdictional sales. The small producers in this proceeding support these suggestions.

We are interested in affording real relief to the small producers and in providing meaningful measures to clear our dockets and facilitate effective regulation. We recognize the burdens to small producers of complying with the filing requirements promulgated pursuant to Section 7 of the Natural Gas Act before new gas supplies can be connected. Such filings, which are routinely handled by the larger companies can, in the case of a small producer, strain his resources. The time lag, even the few weeks required under our expedited procedures, can deprive a

small producer of badly needed income. In light of these circumstances the Commission finds that it is necessary and appropriate to afford the small producers relief as provided below and we are issuing a notice of proposed rulemaking, this date, to implement our conclusions.

A small producer is thereby defined to be a natural gas company selling jurisdictionally less than 10,000,000 Mcf annually on a nationwide basis. Such a classification will include almost 250 of the filing producers in the Permian Basin and leave about 40 major companies subject to the filing requirements of Section 7 for individual sales. Nationally this breaking point would classify approximately 2,000 producers as small and about 75 as major companies. We believe that the record amply supports this reasonable classification made pursuant to Section 16 of the Act. For this purpose, the combined jurisdictional sales of affiliated companies (as further defined in the rule issued this date) will be considered as the sales of a single producer.

Companies or individuals in the Permian Basin qualifying as small producers will be granted small producer certificates pursuant to Section 7 of the Act authorizing all future small producer sales (as defined therein) in the area at or below the applicable area ceiling rate, thereby eliminating the need to obtain separate certificates for each sale as is presently required. This action will not only relieve the producers and the Commission of a large paperwork problem, it will enable small producers to bring their gas to market without any regulatory delay.

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Sales in areas other than the Permian Basin by small producers will not be eligible for coverage by such certificates until an area rate is fixed therein because the determination of a specific area rate is a prerequisite for the issuance of such certificates.

All producers in the Permian Basin who apply and qualify as small producers under our proposed rule issued this date will be granted special certificates as to their Permian sales which will cover not only any future small producer sales (as defined therein) made within our area ceiling prices, but also all such sales for which a separate certificate has already been issued. Naturally, these certificates will be subject to the limit of 10,000,000 Mcf of annual jurisdictional sales on a nationwide basis and to area rate limitations. Those certificate applications within the ceiling pending before the Commission by small producers in the Permian Basin that come within the proposed rule will be covered within small producer certificates and any applications for certificates above ceiling will be granted conditionally upon acceptance of an initial price no higher than the ceiling.

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Recipients of the small producer certificates will be required only to file annually a simple one-page statement in which they will state the total volume of jurisdictional

sales and certify that all such sales were within the applicable area ceiling. The producers holding such certificates will no longer be compelled to file Forms 301-A or 301-B,[51] nor will they be required to file individual initial rate schedules pursuant to Section 4(c) of the Act for the small producer sales. Furthermore, in light of our decision to accept all rate increases up to the area rate, holders of small producer certificates will not hereafter be required, under Section 4(d) of the Act, to file such changes for their small producer sales as they are made. Section 4(d) requires such filings "Unless the Commission otherwise orders * * *." We believe that inclusion of information pertaining to these changes, in the annual reports of the pipeline purchasers, will satisfy not only the language but also the purpose of Section 4(d). Of course, no increases above the applicable area ceiling will be permitted without the approval of the Commission pursuant to the filing requirements of Section 4(d).

Should a producer cease to be a small producer by virtue of an increase of jurisdictional sales to a level in excess of 10,000,000 Mcf in a year, or should he propose to sell at prices above the area rate, or should he make sales which do not qualify as small producer sales he must abide by the present requirements, *i.e.*, his certificate will not apply to such situations. Specific details of the small producer relief are explained in the Notice of Proposed Rulemaking issued this date.

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[51] Presently required by the Regulations under the Natural Gas Act, Sections 260.5 and 260.6.

MISCELLANEOUS ISSUES

Favored-Nation and Spiral Escalation Clauses

The Presiding Examiner stated:

> . . . Most favored nations clauses and spiral escalation clauses cause price increases in a contract price to occur without reference to the circumstances or economics of the particular operation, but solely because of what happens under another contract. These clauses contravene the public interest and the basis on which prices have been determined in this decision. They are therefore declared to be inoperative and of no legal effect. No change in a rate resulting from such indeterminate pricing provisions will be permitted to take effect under this decision and order. (Initial Decision, p. 74)

The examiner correctly observed that most favored-nation clauses and spiral escalation clauses are not in accordance with the principles upon which a rate structure should be based. We have proscribed the filing of contracts containing such clauses executed on or after April 2, 1962. (Order No. 242, 27 FPC 339; *F.P.C.* v. *Texaco,* 377 U.S. 33.) We do not think, however, that such clauses in contracts already accepted for filing at the time of our order outlawing such clauses for the future should be denied effect insofar as they serve to permit filings up to the applicable area prices prescribed herein. When the contracts containing such clauses were negotiated such

clauses were a part of the bargain arrived at between the parties. Had they been proscribed at that time, escalation clauses of permissible types might well have been substituted. In any event there is no reason in the public interest to prevent rate adjustments which will permit producers to collect a just and reasonable price for their gas. These indefinite escalation clauses will, of course, like all other escalation clauses, be subject to the moratorium provisions discussed *supra* at pages 107-114 and, as the examiner ruled, such clauses will not be permitted to authorize rate filings above the applicable area rates subsequent to the expiration of the moratorium period.

Application of the Order

This proceeding, instituted under Section 5(a) of the Natural Gas Act, will determine the just and reasonable rates to be hereafter observed and in force for all jurisdictional sales being made under respondents' rate schedules. Such rates will apply as ceilings to all sales of respondents whether they were being made at the time we instituted this proceeding or were begun subsequent thereto. Certain of the respondents argue that our order cannot apply to rates established in contracts filed by such respondents after this proceeding was instituted. The argument has no merit. The evidence in this proceeding is based on a composite showing of the overall production in the area and fixes an area rate specifically designed to be just and reasonable for all jurisdictional sales in the area.

To hold otherwise would require an unending succession of Section 5 area rate proceedings, each covering only the sales instituted prior to the institution of the proceeding. We are not required to engage in any such massive duplication of effort. This proceeding was instituted to determine the just and reasonable rate or rates for the sales of natural gas produced in the Permian Basin subject to the jurisdiction of the Commission (Ordering Paragraph "A" of Order Instituting Hearing, 24 FPC 1121 (1960)). Consistent with the provisions of Section 5(a) of the Act, our Order will apply to all of respondents' sales in the described area. (See *United Gas Co.* v. *Mobile Gas Service Corp.*, 350 U.S. 332, 341 (1956)).

A few certificates have been issued since the institution of this proceeding authorizing sales in the Permian area by persons not respondents in this proceeding. Our Order here will not apply to these sales, but the parties making such sales will by separate order be directed to show cause why the area rates should not be applied to them.

Finally, with respect to certain of respondents' sales, increased rates have been filed subsequent to the institution of this proceeding and the dockets involving such increased rates (collected subject to refund) have not been consolidated herein. The above-stated reasons why our determination should apply to newly certificated sales is equally applicable to these nonconsolidated increased rate filings and the record in this proceeding would appear to

be adequate to determine the rates to be hereafter collected for these sales and to determine refund obligations. However, the dockets involving the increased rates were not consolidated herein and the respondents have not been afforded a hearing respecting their refund obligations. Accordingly, we shall not order refunds in these dockets but instead institute a separate proceeding requiring respondents to show cause why the rates here determined should not be utilized in determining their refund obligations.

Examiner's Witness Frazier

Continental (Brief on Exceptions, p. 78) on behalf of the Major Producer Group contends that the presiding examiner improperly called as his own witness Charles H. Frazier, then Director of Development for the Philadelphia Gas Works Division of The United Gas Improvement Company, and that he used Mr. Frazier's testimony as the basis for the dual pricing system, his pricing and location differentials, and rate design. The Major Producer Group argues that the burden of proof is the Commission's and that in the Section 5 part of the proceeding, it is well-settled that the commingling of the investigatory and adjudicatory phases of an administrative proceeding violates due process of law and the specific requirements of the Administrative Procedure Act. They note that Section 1.30(f) of our Rules, like Section 5 of the Administrative Procedure Act, provides that one engaged in the investigatory phase must not participate in the decisional process.

It should first be observed that neither Section 5(c) of the Administrative Procedure Act nor Section 1.30(f)

of our Rules by its terms applies in rate proceedings. Thus, even if it were assumed that the examiner in calling his own witness was acting in an "investigative" role, he

did not violate either the Act or the Rules. More important, however, the examiner's action was not "investigative" but a proper function of the trial examiner in a hearing. Both the Senate and House Committee Reports on the Administrative Procedure Act expressly point out that hearing officers "have the authority and duty — as a court does — to make sure that all necessary evidence is adduced."[52] The Act confers authority for what the examiner has done (see Section 7, *passim*). We also note that the state courts have approved the action of a judge in calling his own witness. *Ramsey* v. *Mading*, 217 Fac. 2d 1041 (Wash. S. Ct.); *Hunt* v. *State*, 248 Ala. 217, 27 So. 2d 186, 193; and *People* v. *Rotello*, 329 Ill. 448, 171 N.W. 540, 542. See also 9 Wigmore, Evidence 267-270; 3 Wigmore, Evidence 151-153; 4 Jones, Evidence 1685.

It is suggested that Witness Frazier may have had an interest in the proceeding because his employer, a gas distributor, though not a party in this proceeding, is an intervener in other area proceedings. This point, however, only goes to the weight to be given his testimony,

[52] Sen. Doc. No. 248, 79th Cong., 2d Sess., page 207. See also House report at page 268.

not its admissibility. If interest in the proceeding were a disqualification most of the evidence in this case would be stricken. See 4 Jones, Evidence, 1865-1966.

Witness Frazier's background and employment status were well known at the time he was called and are a matter of record. Respondents were given a full opportunity to cross-examine Frazier and to bring out anything which would impeach him either by way of challenge to his qualifications as an expert witness or challenge to his views because of his interest. His testimony, of course, is entitled to no more credence because he was called by the examiner rather than by a party. We conclude that the calling of Witness Frazier was proper and has not been shown to have resulted in any prejudice to respondents.

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The Commission further finds:

(1) Each of the respondents listed in Parts I and III of Appendix A to this opinion is, and at the time of all past sales with which we are here concerned was, a natural gas company within the meaning of the Natural Gas Act and is engaged in the sale of natural gas in interstate commerce for resale for ultimate public consumption, subject to the jurisdiction of this Commission.

(2) Past, present, and proposed sales of natural gas to which the order herein applies are subject to the jurisdiction of this Commission.

(3) Rates for all sales of natural gas, by the producers in Texas Railroad Districts 7-C and 8 and New Mexico counties Lea, Eddy and Chavez which are respondents herein, that are above the applicable area rates prescribed herein, have not been shown to be just and reasonable or otherwise lawful under the provisions of the Natural Gas Act and should be disallowed, and refunds should be required as hereafter provided.

(4) The just and reasonable rates for past, present and proposed sales of natural gas to which this order applies are the applicable area rates set forth in ordering paragraphs (A) and (B) below.

(5) It is necessary and appropriate and in the public interest to establish minimum rates as provided in ordering paragraph (G) for all natural gas produced in the Permian Basin.

(6) Contracts providing for rates in excess of the applicable just and reasonable rates determined herein or below the minimum rates herein established are in that respect unjust and unreasonable.

(7) The moratorium until January 1, 1968, upon the filing of price increases above the just and reasonable rates established herein is necessary to the practical administration of area rate ceilings and the effective price regulation of natural gas producers.

(8) Except as herein granted the exceptions to the initial decision and proposed order should be denied.

The Commission orders, pursuant to Sections (4e) and (5a) of the Natural Gas Act

(A) *The Base Area Rates*

The following base area rates are hereby established, as of the effective date hereinafter defined, as the just and reasonable rates for sales of gas for resale in interstate commerce by the respondents in this proceeding, subject to any applicable adjustments for quality as provided in ordering paragraph (B) hereof:

(1) For new gas-well gas, as defined in this opinion, sold and to be sold pursuant to contracts executed on or after January 1, 1961, and any residue gas derived therefrom:

a. In Texas Railroad Districts No. 7-c and 8 — *16.5 cents per Mcf* (at 14.65 psia).

b. In Lea, Eddy and Chaves Counties in New Mexico — *15.5 cents per Mcf* (at 14.65 psia) plus the applicable state and local production taxes in effect on the effective date hereinafter defined.

(2) For gas-well gas, sold and to be sold pursuant to contracts executed before January 1, 1961, and any residue gas derived therefrom, and for all casinghead gas and any residue gas derived therefrom sold and to be sold:

a. In Texas Railroad Districts No. 7-c and 8—*14.5 cents per Mcf* (at 14.65 psia).

b. In Lea, Eddy and Chaves Counties in New Mexico—*13.5 cents per Mcf* (at 14.65 psia) plus the applicable state and local production taxes in effect on the effective date hereinafter defined.

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(B) *Quality Standards and Adjustments to the Base Area Rates*

(1) The base area rates fixed in ordering paragraph (A) herein shall be adjusted for any deviations from the standards for pipeline quality gas in Texas Railroad Districts Nos. 7-c and 8, and in the New Mexico counties of Lea, Eddy and Chaves, which are hereby established as follows:

a. *Carbon Dioxide:* Pipeline quality gas shall contain not more than 3 percent carbon dioxide by volume.

b. *Hydrogen Sulphide:* Pipeline quality gas shall contain not more than 10 grains of hydrogen sulphide per Mcf of natural gas at 14.73 psia and 60° F.

c. *Total Sulphur:* Pipeline quality gas shall contain not more than 200 grains of total sulphur per Mcf of natural gas at 14.73 psia and 60° F.

d. *H_2O:* Pipeline quality gas shall contain not more than .009 pound of H_2O per Mcf of natural gas at 14.73 psia.

e. *Other Impurities:* Pipeline quality gas shall contain no oxygen, dirt, dust, gum, or other impurity in sufficient amounts to require the buyer to incur processing costs to eliminate such im-

purities in order for the gas to meet either customary commercial standards or the customary requirements of any of the interstate pipelines in the area.

f. *Pressure:* Pipeline quality gas shall be delivered at a pressure of not less than 800 pounds per square inch.

g. *Btu Adjustment:* (For new gas-well gas only). The maximum standard will be 1,050 Btu's per cubic foot at 14.73 psia and 60° F. and the minimum standard will be 1,000 Btu's per cubic foot at 14.73 psia and 60° F. Upward and downward

adjustments of the base area rates will be permitted on a proportional basis as specified at pages 99-100 of this opinion if the Btu content exceeds the maximum standard or is below the minimum standard.

(2) When a purchaser buys gas which deviates from the quality standards established in subparagraph (1) above, the base area rate fixed in ordering paragraph (A) shall be adjusted for any deviations from such standards as follows:

a. The applicable base area rate shall be adjusted downward by the net cost of processing the gas to bring it up to standard.

(i) If the processing is performed by the purchaser, a reasonable return upon the net investment should be included as part of the processing cost incurred in bringing the gas up to pipeline quality.

(ii) If processing reduces the volume of the gas, the purchaser shall pay for only the volume remaining after processing.

b. The applicable base area rate for new gas-well gas only shall be adjusted downward or upward by the amount of any applicable Btu adjustment and by the concomitant amount of any saving or additional expenses to the seller from any reduction or increase in taxes or royalty payments resulting therefrom.

(C) Applicable area rate, as that term is used herein, shall mean the base area rate established by ordering paragraph (A) or the rate determined after adjustment, if any, of that base area rate for the deviations from the quality standards established by ordering paragraph (B).

(D) The applicable area rate as defined in ordering paragraph (C) above, shall be effective from and after the effective date hereinafter defined and any amounts collected in excess thereof from and after such effective date shall be subject to refund plus interest at 7 percent. In addition,

with respect to the rates involved in the Section 4(e) proceedings set out in Part III of Appendix A, the applicable area rate as defined in paragraph (C) above, shall be effective from the date such Section 4(e) rates were collected subject to refund and all amounts collected under those Section 4(e) rates in excess of the applicable area rate shall be subject to refund from the date such excess was collected plus interest at the rate

specified in the respective Section 4(e) proceeding, in accordance with the provisions of ordering paragraphs (I) and (J) herein.

(E) Within 45 days from the effective date hereinafter defined each respondent shall file a supplement to each applicable rate schedule, effective as of the effective date hereinafter defined, reflecting any reductions required to bring any or all of its rates into conformity with the applicable base area rate established by ordering paragraph (A) herein.

(F)(1) Within 90 days from the effective date hereinafter defined, each respondent listed in Part I or Part III to Appendix A (except those exempted by subparagraph (3) hereof) shall file with the Commission a statement in conformity with Appendix D to this opinion for each rate schedule such respondent has on file with this Commission for the sale of natural gas produced or sold within Texas Railroad District No. 7-c, Texas Railroad District No. 8, or the New Mexico counties of Lea, Eddy or Chaves. Such statement shall set forth either that the gas accords with all pipeline quality standards established herein, or in which respects the gas deviates from the particular quality standards established herein; the agreed cost to the purchaser of processing the gas to bring it to the pipeline quality standards established herein with respect to each quality deviation; any upward or downward Btu adjustment for new gas-well gas; and the resulting applicable area rate for the gas. Such statement shall be signed by both the seller and the purchaser. If the seller and the purchaser

(ii) If processing reduces the volume of the gas, the purchaser shall pay for only the volume remaining after processing.

b. The applicable base area rate for new gas-well gas only shall be adjusted downward or upward by the amount of any applicable Btu adjustment and by the concomitant amount of any saving or additional expenses to the seller from any reduction or increase in taxes or royalty payments resulting therefrom.

(C) Applicable area rate, as that term is used herein, shall mean the base area rate established by ordering paragraph (A) or the rate determined after adjustment, if any, of that base area rate for the deviations from the quality standards established by ordering paragraph (B).

(D) The applicable area rate as defined in ordering paragraph (C) above, shall be effective from and after the effective date hereinafter defined and any amounts collected in excess thereof from and after such effective date shall be subject to refund plus interest at 7 percent. In addition,

with respect to the rates involved in the Section 4(e) proceedings set out in Part III of Appendix A, the applicable area rate as defined in paragraph (C) above, shall be effective from the date such Section 4(e) rates were collected subject to refund and all amounts collected under those Section 4(e) rates in excess of the applicable area rate shall be subject to refund from the date such excess was collected plus interest at the rate

specified in the respective Section 4(e) proceeding, in accordance with the provisions of ordering paragraphs (I) and (J) herein.

(E) Within 45 days from the effective date hereinafter defined each respondent shall file a supplement to each applicable rate schedule, effective as of the effective date hereinafter defined, reflecting any reductions required to bring any or all of its rates into conformity with the applicable base area rate established by ordering paragraph (A) herein.

(F)(1) Within 90 days from the effective date hereinafter defined, each respondent listed in Part I or Part III to Appendix A (except those exempted by subparagraph (3) hereof) shall file with the Commission a statement in conformity with Appendix D to this opinion for each rate schedule such respondent has on file with this Commission for the sale of natural gas produced or sold within Texas Railroad District No. 7-c, Texas Railroad District No. 8, or the New Mexico counties of Lea, Eddy or Chaves. Such statement shall set forth either that the gas accords with all pipeline quality standards established herein, or in which respects the gas deviates from the particular quality standards established herein; the agreed cost to the purchaser of processing the gas to bring it to the pipeline quality standards established herein with respect to each quality deviation; any upward or downward Btu adjustment for new gas-well gas; and the resulting applicable area rate for the gas. Such statement shall be signed by both the seller and the purchaser. If the seller and the purchaser

are unable to agree upon any or all of the particulars entering into the computation of the applicable area rate, the seller shall file the statement herein required which shall indicate the absence of agreement and supply the information required to compute the applicable area rate as well as the contentions of the parties with respect to the quality and amount of the adjustment for any item in dispute. The purchaser may file a separate statement setting forth its views within the period herein provided.

(2) The statement filed hereunder which reflects full agreement between seller and purchaser shall be deemed accepted by the Commission unless the Commission, within 60 days after such filing, shall otherwise order. In the event of disagreement between the seller and purchaser or, where the Commission otherwise determines that the statement filed is inconsistent with the provisions of ordering paragraph (B) herein, the Commission will, after appropriate proceedings, prescribe the applicable area rate to be applied as of the effective date hereinafter defined.

(3) Any respondent listed in Part I or Part III to Appendix A is exempt from filing the statement required by subparagraph (1) hereof for any sales which are "small producer sales" as defined in the rule providing for small producer certificates proposed this date, if within 45 days from the effective date hereinafter defined such respondent files the information requested in Appendix E to this

opinion required to qualify for a small producer certificate for such sales. If the Commission subsequently finds that such a producer does not qualify as a small producer such applicant shall be required to file the statement required by subparagraph (1) hereof within 90 days after any such Commission finding.

(G) *Minimum Rates*

(1) Minimum rates for natural gas produced in the Permian Basin area are hereby established as follows:

For gas meeting all pipeline quality standards *9 cents per Mcf* at 14.65 psia.

For gas not meeting all pipeline quality standards as established herein *9 cents per Mcf* reduced by the amount of any adjustments for quality as provided in ordering paragraph (B).

(2) All respondents who are currently making sales subject to the jurisdiction of this Commission and produced in Texas Railroad District No. 7-c, Texas Railroad District No. 8, or any of the New Mexico counties of Lea, Eddy or

Chaves, are hereby authorized to apply for increases to the minimum rates fixed in subparagraph (1) hereof. Such applications shall be accompanied by the information required in Appendix D to this opinion, signed by the seller (or the agent or operator). Increases to the established applicable minimum rate will be granted notwithstanding

contractual provisions to the contrary which are hereby modified *pro tanto*.

(H) *Moratorium on Rate Increases*

No respondent listed in Part I and Part III of Appendix A to this opinion shall file any change in rate providing for a price in excess of the applicable area rate prior to (1) subsequent order of the Commission in this proceeding permitting such filing or (2) January 1, 1968, whichever is earlier. All contracts of the respondents listed in Part I of Appendix A relating to sales of natural gas subject to the jurisdiction of this Commission and produced in Texas Railroad District No. 7-c, Texas Railroad District No. 8, or any of the New Mexico counties of Lea, Eddy or Chaves shall be deemed amended, pursuant to Section 5(a) of the Natural Gas Act, by the inclusion of the following language:

> From the effective date of the order of the Federal Power Commission in the Permian Basin Area Rate Proceeding, AR61-1, (therein defined as September 1, 1965), until January 1, 1968, no increase in rates may be filed, except in compliance with a specific order of the Commission for a rate in excess of the applicable area rate as determined pursuant to said proceeding or pursuant to later order of the Commission.

(I) *Refund Reports*

Within 120 days from the effective date hereinafter defined a refund report shall be filed with this Commission in triplicate by each respondent involved in one or more of the Section 4(e) proceedings set out in Part III of Appendix A to this opinion. The report shall set forth

the following information (if more than one rate schedule is involved the respondent shall supply the information for each schedule separately):

(i) The rate collected during the period subject to refund, and the periods during which each rate was collected.

(ii) The volume of gas sold at each such rate.

(iii) The difference between the total amount collected during the period subject to refund and the applicable area rate as defined herein. If seller and buyer do not agree upon the items necessary to the computation of said rate, the seller shall make this computation on the basis of the information supplied by the seller in the statement required by ordering paragraph (F) subject, however, to the terms of subparagraph (2) thereof.

(iv) The interest, at rates as specified in each Section 4(e) proceeding, on the amount collected during said period in excess of the applicable area rate. The interest shall be calculated to the date of the report.

(J) *Treatment of Refunds*

Each respondent shall retain the amounts shown in the report required under ordering paragraph (E) subject to further order of the Commission directing the disposition of those amounts. If a respondent elects to commingle these retained refunds with its general assets and use them for its corporate purposes, and after notice to the Commission it is specifically authorized so to do, it shall pay

interest thereon at the rate of 4.5 percent per annum on all funds thus available from the date of the filing of the refund report to the date on which they are paid over to the person ultimately determined to be entitled thereto in a final order of the Commission. If a respondent elects to deposit the retained refunds in a special escrow account, the respondent shall tender for filing on or before the date of the filing of the refund report an executed Escrow Agreement, conditioned as set out below accompanied by certificate showing service of a copy thereof upon each of its jurisdictional customers. Unless notified to the contrary by the Secretary within 30 days from the date of filing thereof, the Escrow Agreement shall be deemed to be satisfactory and to have been accepted for filing. The Escrow Agreement shall be entered into between respondent and any bank or trust company used as a depositor for funds of the United States Government and the agreement shall be conditioned as follows:

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(1) Respondent, the bank or trust company, and the successors and assigns of each, shall be held and formally bound unto the Federal Power Commission for the use and benefit of those entitled thereto, with respect to all amounts and the interest thereon deposited in a special escrow account, subject to such Agreement, and such bank or trust company shall be bound to pay over to such persons or persons as may be identified and designated by final order of the Commission and in such manner as may

be therein specified, all of any portion of such deposits and the interest thereon.

(2) The bank or trust company may invest and reinvest such deposits in any short-term indebtedness of the United States or any agency thereof or in any form of obligation guaranteed by the United States which is respectively payable within 120 days as the said bank or trust company in the exercise of its sound discretion may select.

(3) Such bank or trust company shall be liable only for such interest as the invested funds described in Paragraph (2) above will earn and no other interest may be collected from it.

(4) Such bank or trust company shall be entitled to such compensation as is fair, reasonable and customary for its services as such, which compensation shall be paid out of the escrow account to such bank or trust company. Said bank or trust company shall likewise be entitled to reimbursement for its reasonable expenses necessarily incurred in the administration of this escrow account, which reimbursement shall be made out of the escrow account.

(5) Such bank or trust company shall report to the Secretary quarterly, certifying the amount deposited in the trust account for the quarterly period.

(K) No respondent shall file hereafter any change in rate providing for a price in excess of the applicable area

where the contractual right to such filing is based upon any contractual provision which would not be permitted by subsections (a), (b) and (c) of Section 154.93 of the Regulations under the Natural Gas Act.

(L) Notwithstanding the issuance of this final order, these proceedings shall remain open for such further action as may be necessary with respect to individual respondents and such other action as may be necessary in the premises.

(M) Except as herein granted the exceptions to the initial decision and proposed order are hereby denied.

(N) The date of issuance of this opinion and order within the meaning of Section 19(a) of the Natural Gas Act is the date shown on page one of the opinion immediately below the title thereof. The term "effective date hereinafter defined" (as it is used in the ordering paragraphs herein) is September 1, 1965.

By the Commission. Commissioner O'Connor filed a separate statement concurring and dissenting on limited issue.

(SEAL)

Commissioner Ross filed a separate statement concurring and dissenting on limited issue.

Commissioner Black filed a separate statement concurring.

Commissioner Bagge not participating.

/s/ J. H. GUTRIDE
Joseph H. Gutride,
Secretary.

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Area Rate Proceeding Claude E. Aikman, *et al.* North Central Oil Corporation, (Operator), *et al.*	Docket Nos. AR61-1 G-18466, *et al.* CI60-435, *et al.*

O'CONNOR, Commissioner, *concurring and dissenting on limited issue:*

(Issued August 5, 1965)

The Commission's decision issued today is a significant event in the evolution of our area rate policies, and, on the basis of the record before us, it establishes just and reasonable rates for natural gas producers in the Permian Basin. It is my opinion that our extensive investigation has been synthesized into a meaningful system of regulation, and, for the purposes of our initial area proceeding, I endorse the consideration of costs. The cost analysis we utilize is a useful and proper determination of the financial requirements of the industry, and the results are defensible. I therefore concur in the Commission's opinion, including, of course, the procedures for implementation of the rates we establish; my dissent is limited to one issue.

While I join for present purposes, I am convinced that the experience gained in this costly and expansive proceeding justifies a simplification of the trial and disposition of future area proceedings. Price control being our objective, it is clear that the interests of producers and consumers can be adequately protected under expedited procedures based upon reasonable market prices. The record in this case fully establishes that the contract price

at which most producers are able and willing to operate is just and reasonable. This standard provides the measure of inducement that has been successful in providing an excellent source of energy for use in all sectors of the Nation. Thereby, any policy that focuses on profits realized, as recommended by some parties before us, would be avoided, and the focus would be on supply elicited, which policy we here endorse. Furthermore, it is preferable to tolerate such imperfections as might result from area regulation in the interest of avoiding complicated cost-plus methodology.

The contract price is the measure of inducement. Composite costs best serve as a check on average field prices to preclude significant price departures. Our judgment should rest primarily on the market place where we can rely on competition to determine just and reasonable rates. In the hope that they will become the rule, I hereby express my additional views and recommendations.

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PRELIMINARY CONSIDERATIONS

In 1954 the Supreme Court made the unexpected determination that this Commission has jurisdiction over the interstate sales of natural gas producers and that it has a corresponding obligation to regulate those sales in the public interest. For fourteen years prior to that decision the Commission had repeatedly rejected the jurisdictional argument, and, due to the obvious difficulty of the task, the Commission had regularly recommended legislation

granting only limited regulation over producers. In 1956 the Congress acquiesced in this view by approving such legislation, only to see it rejected by Presidential veto for reasons totally removed from the merits of the bill itself. Today, more than a quarter-century after the Natural Gas Act was adopted, and eleven years after this Commission was granted jurisdiction over producer sales, a decision has been reached which accommodates to an intent that prices for natural gas be regulated. However, although the law compels an embarkation into price control during peacetime, it does not dictate a single methodology, and herein lie my separate recommendations for future area decisions.

The task of selecting a reasonable approach to regulation that will reflect the practical necessities before us is a difficult one, but cognizance of several factors will make an acquittal of the duty more meaningful. The production of natural gas is an industry in which there is an intricate interplay of special market circumstances. Pipeline control over field prices presents awesome monopsonistic powers. Problems of waste and correlative rights compel state conservation regulation. Shared problems with oil lead to an overlapping of economic interests. Public utility characteristics at the transmission and distribution end go so far as to generate demands for price controls over the producing industry. The absence of traditional public utility characteristics in the production of natural gas presents problems that are directly antithetical to the transmission or distribution of the commodity; there is not the same direct relationship between investment and

output at the crucial focus of the individual company, and there is certainly no legal obligation to provide new services. Reflecting these multifarious consideration, Justice Jackson observed, "If natural gas rates are intelligently to be regulated we must fit our legal principles to the economy of the industry and not try to fit the industry to our books." *F.P.C. v. Hope Natural Gas Co.*, 320 U.S. 591, 650 (1944). In that opinion he emphasized,

> It is necessary to a "reasonable" price for gas that it be anchored to a rate base of any kind? Why did courts in the first place begin valuing "rate bases" in order to "value" something else? The method came into vogue in

> fixing rates for transportation service which the public obtained from common carriers. The public received none of the carrier's physical property but did make some use of it. The carriage was often a monopoly so there were no open market criteria as to reasonableness. The "value" or "cost" of what was put to use in their service by the carrier was not a remote or irrelevant consideration in making such rates. Moreover, the difficulty of appraising an intangible service was thought to be simplified if it could be related to physical property which was visible and measureable and the items of which might have market value. The court hoped to reason from the known to the unknown. But gas fields turn this method topsy turvy. Gas itself is tangible, possessible, and does have a market and a price in the field. The value of the rate base is more elusive than that of gas. It consists of intangibles — leaseholds and freeholds — operated and unoperated — of little use in themselves except as rights to reach and capture gas. The value lies almost wholly in predictions

> of discovery and of price of gas when captured, and bears little relation to cost of tools and supplies and labor to develop it. Gas is what Hope sells and it can be directly priced more reasonably and easily and accurately than the components of a rate base can be valued. Hence the reason for resort to a roundabout way of rate base price fixing does not exist in the case of gas in the field. 320 U.S., 647-48.

Regulatory authority must be employed as the characteristics of the industry dictate. Congress and the courts have refused to confine permissible principles of procedure to a narrow corridor; by granting the Commission flexibility, they implicitly recognized the wisdom of the Justice's words.[1]

By these distinct considerations, the purpose and the method of price regulation is presented in its proper perspective, and they should dictate the results required. Where a compulsory service obligation exists the only regulatory problem is to appraise a service that must, of legal necessity, be rendered. Where the output is direct and constant, the value of the service thus performed, in terms of the allowed rate, can legitimately be referenced to a reasonable yield on the actual costs involved. In the absence of this obligation, however,

the role of appraising the services performed assumes a decidedly different function: the problem becomes that of

[1] See, e.g., *Wisconsin* v. *F.P.C.*, 373 U.S. 294 (1963); *Colorado Interstate Gas Co.* v. *F.P.C.*, 324 U.S. 58 (1945); *F.P.C.* v. *Natural Gas Pipeline Co.*, 315 U.S. 575 (1942); *Bel Oil Corp.* v. *F.P.C.*, 255 F.2d 548 (5th Cir. 1958); *Forest Oil Corp.* v. *F.P.C.*, 263 F.2d 622 (5th Cir. 1959).

fixing a price based, not only upon what must be performed, but primarily upon what will induce the product. The regulatory emphasis shifts. It is not so much actual cost as it is market cost; not only prudent return but incentive prices; not just cost of service but also cost of supply. These multifarious considerations are so well established that there should be no need for further discussion. They were made explicit in our decision to focus on area rate-making and have been consistently reaffirmed. *Phillips Petroleum Company* 24 F.P.C. 537, 542-548 (1960); *aff'd,* 373 U.S. 294, 308-310 (1963). That decision compels thorough consideration of the factors that determine a reasonable market price.

It has been argued that *en masse* cost proceedings contain an inherent incentive for low cost producers since their profits are limited only by ceilings premised on much higher costs. Group cost proceedings may offer more incentives than individual proceedings, but if the history of pipeline production and its regulation by this Commission on an individual cost basis is any indication, cost regulation as a general principle in utility regulation does not provide the necessary system. By such control, there has been a 25 per cent decrease in the ratio of actual pipeline production over a six-year period: in 1957, pipeline production was 11.69 per cent of purchases; in 1958, 10.56 per cent; in 1959, 10.87 per cent; in 1960, 10.38 per cent; in 1961, down to 9.57 per cent; and in 1962, only 8.78 per cent. See *Sales by Producers of Natural Gas to Natural Gas Pipeline Companies* (F.P.C. 1963). These statistics are for individual companies as composited on an annual basis.

It has also been argued that, if total industry costs plus a reasonable return are recovered, then gas will continue to be found. Total costs are not recovered under group cost regulation; the higher cost producers, which must be considered in any statistical compilation, will still not be made whole. Moreover, gas is found by the individual decisions and acts of thousands of producers. To them, incentives must relate to profits available in other sectors of the economy. If the maximum price any one producer can obtain from his production is insufficient, as he might determine *vis-a-vis* his own interests and alternative investments, it is of little concern to him that the ceiling was premised on the larger percentage of the industry's costs. So long as there is a reasonable likelihood that his prices will be reduced below his contract terms or his certificate conditions, he will not have the necessary incentive to commit funds for further exploration.

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I emphasize, in full agreement with our opinion, that the area rates we are to determine have a single, overriding purpose: to control the available supply of natural gas; and those rates have but one utilitarian function: to be high enough, but only high enough, to accomplish this policy function. In the context of area pricing, just and reasonable rates can best be used as a measure to elicit the necessary supply. So viewed, price control is the overriding policy. The function should be accomplished, and the standard should be employed, in the most direct and least dilatory manner possible.

REGULATION BASED SOLELY ON COSTS

The Commission places primary reliance for its answer in this initial case upon cost-plus regulation. This accepted formulation is little more than individual cost of service applied on an area basis to an averaging of composite costs. In making this determination, we must grapple with Gordian problems that do not readily accommodate to precise disentanglement; for our purposes here, cost analysis defies mathematical logic. Nevertheless, the focus in this proceeding on such costs make it both necessary and proper that we determine the financial requirements of the industry.

Costs as a Basis for Comparison

The major emphasis in the Commission opinion on cost-plus regulation appears to stem from a conviction that costs *must always* be the primary basis for regulation. I believe we have more flexibility, particularly for future proceedings, than is suggested there. The leading authority on this issue is *F.P.C.* v. *Hope Natural Gas Company*, 315 U.S. 575, where the Supreme Court declared:

> It is not the theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unjust or unreasonable, judicial inquiry is at an end. The fact that the method employed to reach that result may contain infirmities is not then important.

The tenor of the above quotation supports the general proposition that regulatory agencies are to be accorded a strong presumption of validity in determinations that

must be based largely on commission expertise. Certainly producer regulation qualifies as a subject matter in which there should be large scope for Commission innovation and adaptation to the economic facts of life in the industry. The Commission opinion, in my view, charts too narrow a course for the future. Cases such as *City of Detroit* v. *F.P.C.*, 230 F. 2d 810 (1956), where the D. C. Circuit Court

reversed a Commission determination which would have allowed a pipeline the field price for its purchases of natural gas from an affiliated producer, do not bind us to costs alone. The Commission had there sought to avoid the complicated and time-consuming "rate-base" method, which is presently relied upon for the flowing gas price albeit on an area basis. The circuit court reversed, holding that the purposes of the Natural Gas Act require that costs be considered; however, the opinion emphasized that this was to be regarded as no more than a starting point. Thus, the Court there stated:

> . . . though we hold that method [the rate base or cost of service method] not to be the only one available under the statute, it is essential in such a case as this, that it be used as a basis of comparison. It has been repeatedly used by the Commission, and repeatedly approved by the courts, as a means of arriving at lawful — "just and reasonable" rates under the Act. Unless it is continued to be used at least as a point of departure, the whole experience under the Act is discarded and no anchor, as it were, is available by which to hold the terms "just and reasonable" to some recognizable meaning.

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The above language was relied upon by the Fifth Circuit in another proceeding, *Bel Oil Corporation* v. *F.P.C.*, 255 F. 2d 548 (1958), where that court was faced with an allegation by certain producers that the Commission should base just and reasonable rates on field prices. The court rejected this contention, saying:

> We cannot agree [to] the proposition that the evidence thus far adduced makes out a *prima facie* case of reasonableness of the contract price of 16 cents. We do not hold that the evidence of field price is irrelevant. We do hold that evidence of unregulated prices in the field is not sufficient to warrant a finding by the Commission that a price comparable to them is just and reasonable within the intendment of the Natural Gas Act. *Id.*, at 553.

The Court further observed:

> The regulation of the prices at which thousands of "natural gas companies" may sell to the pipeline companies is a difficult one at best. It is a field which in many respects requires new formulas to test what is just and reasonable.

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Rebutted in efforts to rely solely on contract prices, the Commission commenced the seemingly interminable task of determining just and reasonable rates to be allowed on an individual company cost of service basis for the country's major producers of natural gas. Realizing the futility of the individual cost approach, the Commission made the necessary determination that area rates be utilized. Significantly, the decision marked a step away from the individual company costs; the emphasis shifted to other economic indicia. New formulae for public util-

ity regulation were necessary. It became possible under area pricing that some producers might not be able to operate under ceilings; it also raised the possibility that many producers would receive high rates of return simply because of the success of their operations. The departure signalled the demise of cost-plus regulation for natural gas producers. Recognition was accorded the fundamental difference that exists between the producer of a commodity and the seller of a service. The latter is readily amenable to utility regulation; the former clearly is not. Significantly, the same court that decided *City of Detroit* affirmed the departure from costs in the *Second Phillips* litigation. In 303 F. 2d 308 (D.C. Cir. 1961) Chief Judge Prettyman, author of *City of Detroit,* declared:

> . . . But what of a fair price for a commodity bought and sold by a merchandiser? Almost the whole of the economics of merchandising differs from the economics of public utility service. Are the just and reasonable prices of such a merchandiser limited to fair returns on his own investment and prices paid by him (and, if so, what investment and what prices), or are those prices reasonably measured by the fair prices for the product as measured by the open competitive market for the product, evaluated by Commission expertise and data on the whole of the market operation? Either criterion is a method of regulation. It seems to us that the choice must lie with the Commission. *Id.*, at 388.

In turn, the Supreme Court affirmed the area approach, 373 U.S. 294 (1963). Significantly, it there declared:

> We recognize the unusual difficulties inherent in regulating the price of a commodity such as natural gas. We respect the Commission's considered judg-

ment, backed by sound and persuasive reasoning, that the individual company cost-of-service method is not a feasible or suitable one for regulating the rates of independent producers. We share the Commission's hopes that the area approach may prove to be the ultimate solution. *Id.*, at 310.

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Although repeating assurances at oral argument that "composite cost-of-service data" would be considered, the Court went on to say that *City of Detroit,* insofar as it required cost regulation, is to be distinguished from area pricing because the circuit court did not have before it any questions relating to the area rate method. This precedent leads inexorably to the conclusion that, even though some consideration of costs may be required for an initial area pricing formula, the cost approach need not, in circumstances of workable competition, be the governing methodology. Nevertheless, five years after the area approach was initiated in *Second Phillips,* and over twenty years after the Court observed that "he who would upset the rate order under the [Natural Gas] Act carries the heavy burden of making a convincing showing that it is invalid because it is unjust and unreasonable in its consequences." . . . *F.P.C.* v. *Hope Natural Gas Co.*, 320 U.S. 591, at 601 (1944), this Commission retains its attachment to cost-plus. In the light of compelling authority, it must be concluded that fears of judicial review need not be entertained to preclude Commission departure from strict adherence to cost-plus. In this proceeding there has been an extensive investigation into the operations of producers, with all parties having received a thorough opportunity to

present their separate views and to review the evidence presented by others. Beyond a doubt, with due consideration being accorded the many difficulties inherent in any cost analysis of a joint product, it is clear that the prices adopted today bear a close and substantial relation to the weighed average prices negotiated in the field. The cost-plus rate and the negotiated contract rate fall within that zone of reasonableness that is essential to regulation. Therefore, it is not required in future proceedings that costs be the beginning and the end of just and reasonable rates. The time is ripe to abandon costs as the sole referential. Among the alternatives, competition has been shown to be sufficient to provide an appropriate and compelling measure of just and reasonable rates.

Inherent Limitations in Cost-plus Regulation

Cost-plus regulation alone is not an objective, independent determinant for just and reasonable prices for producers. Any determination upon evidence of costs will necessarily depend on numerous pragmatic adjustments that will, without consideration in detail of other relevant factors, permit a certain amount of variation that could otherwise be controlled. It is no difficult matter to appreciate the problem. Staff concedes that "costing for producers of gas is not, and likely never will become, as precise as is customary in utility regulation." The major inherent difficulties are fourfold.

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Fundamentally, the factual and statistical presentations relied upon in the main opinion are but estimates. There

are immense difficulties in the collection, selection, and presentation of data. Voluminous questionnaires are issued, but many go unreturned. Staff Appendix data in the largest of the five size categories is based on 93.8 per cent of the producers. In the next largest group only 30.9 per cent are available. The percentages are dropped drastically to 8.0 per cent in the third group, to 2.7 per cent in the fourth, and to but 0.8 per cent in the smallest. Although the excellent response in the largest category does provide good area cost coverage, there is a notable exception by the absence of crucial exploratory drilling costs. Specifically, unrecorded dry holes are of necessity incomplete. Any meaningful anticipation of probable accuracy is weakened by an absence of fully reliable statistical verity. Perhaps these deficiencies could be cured in the future, but the precipitous decrease for available questionnaire data on the small producer groups presents more fundamental problems, particularly since the small producers drill the greater proportion of exploratory wells. The smaller producers operate on extremely limited resources and are thus less likely to maintain books that would be adequate to provide meaningful replies. While 67 of 68 Appendix B questionnaire responses for the second largest group are acceptable for compositing purposes, 46 of the 105 Appendix C responses were inconsistent or incomplete to the extent that their data was entirely excluded. Consequently, as sales and production volumes decrease data credibility likewise decreases. Exhibit 255, among others, indicates there is an exact inverse relationship between sales volumes and per unit costs; as the former decrease, the latter increase. This statistical inac-

curacy means that primary reliance on questionnaire data places the small producer — the one most likely to be undercut through *enmasse* normative costing — in a triple squeeze: due to the high cost of compilation, a low percentage can submit cost data; a high percentage of the data submitted must thus be rejected; and such responses as finally filter into a composite exhibit must be discredited for low coverage on a voluntary basis.

Despite these inherent deficiencies, the issuance of the questionnaires is not inutile. To the contrary, their submission has been of notable assistance in arriving at rates which are just and reasonable, and in establishing, as evidenced in our opinion, that negotiated field prices are within the permissible zone of reasonableness, even from a cost perspective.

Of necessity, the Commission had to supplement questionnaire data by amplifying the information available from various published sources. Although this reinforces some aspects of

data reliability, other problems arise in proportion. The separate publications are usually limited to the very large operators, and are thus even more restricted than under the questionnaire responses. Coverage of these outside sources is usually national and international, so that expenditures are presented in broad categories that portray many meaningful items in a single dollar total; consequently, specific cost items that should require special regulatory treatment cannot be separately identified for

the Commission's purposes. As various sources are necessarily utilized, approximation of these unknown components is effectively prevented by the obscure or overlapping categorizations used by each source. Statistical probability thus declines and, although such cost analysis provides a "zone of reasonableness" within which the required pragmatic adjustments can properly be made, there is no precise objective standard for the purposes of the industry.

After the cost components are adopted, the circular ceremony known as cost allocation begins. We have avoided some of the pitfalls, but our reliance on even the semblance of allocation requires that we exercise our judgment within a fairly broad range of rates. By definition, allocations occur because certain costs cannot be directly identified with certain functions of the various identifiable products or assets, and allocated costs thus present a distinct existence apart from directly ascertainable costs. Where the ratio to total industry costs is small, the gaps are insignificant; however, as the ratio increases, both the costs and the resulting rates, to the extent directly transferred, become less reliable and more subject to adjustment. As the speculative base becomes more pronounced, the choice of allocation formulae can produce a wider range of rates, but the logical relationship between any resulting rate and the current costs of supply becomes even more remote. Although the courts may have declared that "It is not the theory but the impact of the rate order which counts," I do not believe that merely because the results reached today are reason-

able and have a valid reference to the prevailing market price at the well-head that cost-plus should be employed in the future as the sole referential. The imprecise determinations can only be a transcendent command unduly complicating later proceedings, and the analytic principles evoked can have but the validity of a foregone conclusion.

The difficulties involved in allocations are not hard to appreciate. The allocations problem confronted by the Commission is that of attributing legitimate, but separate, costs to a largely joint product. According to witness Sherwin,

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the costs attributable to associated gas are 100 per cent joint, as that term is technically employed, and, for non-associated gas, 31 per cent joint and 24 per cent shades of joint and common. Thus, even for non-associated gas, only 45 per cent of the costs are directly attributable to the product committed to our jurisdiction. The Commission has previously stated the implications of this:

> While we must make allocations in all rate cases, the amounts involved in electric and gas pipeline cases have been comparatively small, and the allocations relatively simple. In the case of a producer, the amounts involved in the allocations of costs are major in size and extremely difficult to make. The result is that a producer actually could become bankrupt, or could make enormous profits, depending merely upon the methods of allocation used. 24 FPC, at 543-544.

Strict adherence to allocation formulae would produce a spectrum of rates so wide and variant as to lend a sophist's support for the extremes, and as a practical matter to be capable of producing clearly unrealistic results. In such a case, as well as in the case of prescribed rates that come to rest somewhere between the extremes, the supposedly independent determination of legitimate costs is actually based upon pragmatic adjustments of either the formulae employed or, in a guise of expertise and trending, of the deceptively precise mathematical resultants. This certainly is no well-guarded secret:

> When an unrealistic result is reached, the formulae for allocations must be changed, in order to bring about a reasonable result. The allocation methods then become a means of supporting a result already arrived at, rather than a means of arriving at a result which was previously unknown. *Id.*, at 544.

Finally, even after statistical costs are collected, compiled, selected, allocated, and invariably trended and modified, they must still be related to reserve additions before the desired costs per Mcf can be found. An understatement of reserves found causes high per unit costs, and thus results in high rates. An overstatement has the reverse results. Despite the confidentiality attached by producers to their reserve figures, the industry's cooperation in this proceeding prompted them to submit a composite exhibit of estimated reserves for the Permian Basin. In addition, there are numerous published sources for reserves estimates. Nevertheless, such figures are no more than estimates, and their estimation entails a considerable degree of subjectivity. This is revealed on the

record before the Commission as was similarly disclosed in the investigation into Phillips' individual costs. See 24 FPC, at 544.

The statutory function of rate regulation is to arrive at reasonable results, and no criticism can be levelled at the attempt to stay within a zone of reasonableness. The use of composite figures to explain economic behavior is clearly a most useful analytic system; however, reliance on allocations, estimates, and other variations of expertise are not the only independent referentials that are desired or that can be utilized.

To the extent that cost analysis is productive of reasonable results, and with one exception our opinion today meets this judicial standard, it would be most helpful for our regulatory purposes if ascertainment of a producer's investment were to be presented on a basis conforming to sound accounting practices. The derivation of a return allowance is a three-step computation: first, ascertainment of the investment; second, determination of the period of time over which the investment is to be allowed a return; and, third, ascertainment of the rate of return. I concur in the Commission's determination on this issue because, on the record in this case, no other disposition is feasible. However, it appears that the yield concept deserves full consideration in future proceedings as a reasonable alternative that might be preferable to traditional methods.

In a 1963 publication by Arthur Andersen & Company, entitled *Accounting for Oil and Gas Exploration*

Costs, it is concluded that the present practice of the industry of expensing exploration and development costs as incurred is in discord with accounting and economic principles. Written for the limited purpose of discussion and study, the publication recommends that leasing, acquisition, carrying, drilling, geological, and other such costs, as well as general and administrative costs related to exploration and overhead, be capitalized and later amortized on an overall unit-of-production basis as production occurs. It states, "[s]uch aggregate costs include nonproductive exploration costs which, in our opinion, are capital in nature," and later, "[t]hey should be capitalized since they are just as much a part of the cost of the reserves found as are the lease and well equipment on the producing wells." The pamphlet recognizes, however, that ". . . appropriate recognition should be given to such current reductions in income taxes as may result from the current deduction of such capitalized costs for income taxes as incurred. This is essential to a proper determination of costs."

The recommendation in the pamphlet may also be sound for regulatory purposes. At least, as recommended by Staff witness

Spain, that portion of it which advocates full cost accounting for all finding expenditures should be thoroughly explored. Any lesser treatment is a refusal to recognize the full cost of acquiring productive assets. Such cost accounting has been undertaken on a very limited basis by the industry, and it appears that the results have pro-

vided more accurate knowledge of the functioning of the industry and of the results of expenditures. Without going into detail at the present, I believe the true yield method may be shown not to change the rates here established. In any event, it is not possible to utilize this control for our decision today: the record is not adequate, the various recommended returns are not directly transferable, and the industry has not generally accepted the principles involved.

AN APPROPRIATE BASIS FOR DECISION

These limitations inherent in cost-plus producer regulation do not, however, spring only from the allocations and adjustments, nor only from the inherent difficulties of data collection, selection, and compilation, nor only from the resulting deficiencies in the construction of a legitimate costing model, nor only through deemphasis of available reserves estimates. I believe the facts in this case reveal that in the future the Commission need not be confined to cost-plus regulation. The accusation of "drastic inflationary cycles" in wellhead prices in the last twenty years stands rebutted. As a matter of general principle, it is not sound to argue that cost-plus regulation cannot be supplemented because the rise in wellhead prices, experienced in the recent past, was due to producer-dictation of contract prices; that those prices were grossly in excess of cost trends; further, that the wellhead price increase was directly reflected in burner tip increases, albeit four-fold that at the wellhead; and, finally, that any attempt to consider factors in addition to cost-plus regulation would constitute an abdication of

responsibility, and would result only in another round of similar, allegedly violent, price jumps.

The propriety of the price rise since 1945

Any detailed discussion of the accusation of price-dictation by producers will not be undertaken here;[2] however, long

experience with the industry is convincing that, where price dictation exists, it is seldom with the seller. All available information and discussion lead persuasively to the conclusion that field prices are set after vigorous bargaining within a context of numerous restrictive economic forces. More particularly, in the Permian, there has been an essentially monopsonistic environment whereby the transmission company in a particular field would set, on a unilateral basis, the fixed, maximum rate for natural gas in the area. Accomplishing this unilateral price-dictation is particularly possible for a company free of economic constraint. This was the situation for El Paso Natural Gas Company. El Paso not only purchases over 70 per cent of the interstate Permian gas, but it also produces over 15 per cent of its total volumetric purchases. In this connection it should be noted, as was established by the record in *United Gas Pipe Line Com-*

[2] The problems are well-documented in numerous professional journals and academic surveys. Reference is made particularly to MacAvoy's *Price Formulation in Natural Gas Fields,* (Yale University Press, 1962); Neuner's *The Natural Gas Industry; Monopoly and Competition in Field Markets,* (University of Oklahoma Press, 1960); and Cookenboo's *Competition in the Field Market for Natural Gas,* (The Rice Institute Pamphlet, 1958).

pany, Docket No. RP63-1, 31 FPC, at 55 (1964), wellhead prices are uniformly depressed in areas where pipeline production is prevalent. Nevertheless, many have argued that, if transmission companies had possessed any bargaining leverage, the recent rise in gas prices *could not have occurred*. This argument must be rebutted.

It is clear that the wellhead price increases of the 1950's began at levels not even remotely approximate to the cost or value of separately found reserves. No responsible authority disputes this position. As late as 1960, this Commission is on record that:

> . . . rigid adherence to the rate base method will, in many cases, price the producers' gas completely out of market. This fact is now abundantly clear: Regardless of variations in allocations methods, allowance for incentives, and other disputed factors, computations of the cost of natural gas which have been presented in the many cases before us show that natural gas has been, in most instances, substantially underpriced. 24 FPC, at 547.

When the Supreme Court ordered Commission jurisdiction over natural gas producers, gas was not paying its own way in the industry. The problem came to the forefront in 1948 when the Commission's *Natural Gas Investigation* established that gas was being wasted in enormous volumes, that it nevertheless had excellent value as a fuel, and that the most effective practice would be to establish a minimum price on sales of gas to pipelines in order to conserve the resource. It is paradoxical that, four years prior to its *First Phillips* decision, the Supreme Court should approve state-imposed minimum

wellhead prices for natural gas to the end that it would not be wasted. See *Cities Service Gas Co.* v. *Peerless Oil and Gas Co.*, 340 U.S. 179 (1950). This disparity between costs and past prices

is indicated by our opinion today.[3] If the analysis we utilize for new gas is applied to the average wellhead price for natural gas in 1947, the difference between the two is at least 2.4¢, with the average contract price being *below* the cost-plus figure. In 1947 gas sold at an average price of 6.0¢, but the Commission's present approach, if applied then, would have resulted in a price of 8.4¢. It was not until the late 1950's, according to the costs established today, that natural gas prices came to approximate the cost-plus rationale utilized by our opinion. Thus, the price rise of the 1950's resulted primarily from the gradual maturation of the natural gas industry into one where the product sold was paying a just return to the independent producer. Particularly anomalous, in view of allegations of "continuing inflation" of natural gas prices, is the fact that such an increased allowance to provide a return on investment and expenses is the least that should be accorded the producer as a result of his elevation to a "natural gas company" under the Act.

In addition to natural gas coming into its own, there were, in the main, four factors that led to increases. *First*,

[3] It is not possible to relate our present cost analysis in precise manner to past prices, primarily because of the absence of questionnaire data. Nevertheless, industry-wide statistics provide a meaningful basis for comparison.

the sudden rise in interstate demand necessitated, because of our regulatory standards, an equally sudden increase in reserve capacity with a concomitant market allocation to the higher usage. *Second,* the resultant of such demand was an activation of favored nation and spiral escalation clauses. *Third,* there was an extensive renegotiation of escalation clauses by pipelines in order to preclude such a repetition. *Fourth,* a competitive buyer's market existed temporarily when transmission companies entered new purchasing areas to negotiate contracts at prices somewhat above then extant market values. It is of special significance that wellhead increases occurred in the latter instance, particularly in the Permian Basin in the late 1950's, for it indicates that, without a competitive purchasing structure, producers are not able to achieve the higher prices. Thus, taking the average wellhead prices for the Permian in 1947 and 1956, the prices were 4.0¢ and 9.7¢ respectively, which are prices significantly less than the costs that have been established by this proceeding. By the rationale today utilized, this Commission could have established maximum prices of 7.2¢ and 12.5¢ in those two years, and the difference between the costs and what El Paso was then dictating amounts to prices some 30 per cent *below* the new gas ceiling that would have then been required.

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Furthermore, it must be emphasized that there is absolutely no support, apart from a so-called "anarchic inflation" allegation discussed hereinafter, that trans-

mission companies, even though they possess superior bargaining leverage, are, because of an alleged ability to shift the costs without concern, indifferent to using this leverage. This accusation has been clearly refuted, not only by the published authorities cited earlier, but by the record before us. Witness Mayer, who has participated for over thirty-five years in the negotiation of sales contracts for Phillips Petroleum Company which is the largest independent producer of natural gas in the United States, and has been a supervisor in the sales division since 1945, testified as follows:[4]

> Q: Turning first to matters of general rebuttal, I direct your attention to the question of the Examiner occurring during cross-examination of Mr. Frazier at Tr. 231/27,003, lines 1-4, concerning the degree of bargaining between pipelines and producers existing in the past and present in the Permian Basin and ask you to state what your experience has been in this regard.
>
> A: I have been intimately involved in negotiations with the pipeline companies in the Permian Basin for nearly twenty years. *I have yet to see the time that the negotiator for the pipeline didn't drive as hard a bargain as he possibly could.* In my opinion, the pipelines have negotiated, and will continue to negotiate, for the purchase of gas in every way which will result in the greatest benefit to themselves and their customers.

This experience of the industry cannot, as a matter of record, be disputed. Significantly, the Examiner, although not fully persuaded on this matter for the entire period of the 1950's, was able to conclude as follows:

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[4] Tr., pp. 28,138-139.

> . . . There is presently intense competition between pipelines for the limited growth in city-gate demand. And now that the city-gate price has advanced materially and distributors' costs have increased, competitive price pressures in the ultimates market have resulted in an added cost consciousness on the part of pipelines.

Since we are here fixing rates for the future, the circumstances with which we should be most concerned are reflected in the above conclusion.

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Reliance need not be placed solely on the above. It is more significant that the rise in the price of natural gas can be fully explained, and that this rise has been part of a long-term picture that cannot be overlooked if there is to be a dispassionate analysis of the price-rise argument. The Bureau of Mines has compiled data in its *Minerals Yearbook* into charts that begin with 1940 or 1945. Such data have been used to emphasize the price rise. This limited survey is misleading because it overlooks the experience of wellhead prices over a twenty-year period prior thereto:[5]

[5] Record Exhibit No. 25, Schedule 2. See also Bureau of the Census, *Historical Statistics of the United States* (1960) and subsequent supplements.

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Year	Price (¢ per Mcf)	Year	Price (¢ per Mcf)	Year	Price (¢ per Mcf)
1922	11.1	1935	5.8	1948	6.5
1923	10.0	1936	5.5	1949	6.3
1924	9.3	1937	5.1	1950	6.5
1925	9.4	1938	4.9	1951	7.3
1926	9.5	1939	4.9	1952	7.8
1927	8.8	1940	4.5	1953	9.2
1928	8.9	1941	4.9	1954	10.1
1929	8.2	1942	5.1	1955	10.4
1930	7.6	1943	5.2	1956	10.8
1931	7.0	1944	5.1	1957	11.3
1932	6.4	1945	4.9	1958	11.9
1933	6.2	1946	5.3	1959	12.9
1934	6.0	1947	6.0	1960	14.0

This complete presentation reflects the full scope of the price history of natural gas production: a germinal period of relatively high prices followed by successively declining periods which resulted in depressed prices that were extremely low; the low point was reached during wartime when price controls were imposed based on market conditions; and finally, there was a period of successive increases during the post-war period responsive to the increased demand. Significantly, these statistics establish that the moving average price in 1954, when federal producer regulation was imposed, was 1.0¢ lower than that of 1922, and

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the oft-emphasized increase from 1950 to 1960 was but 0.9¢ greater than the seldom emphasized decrease from 1922-1940.

Even the increase from 1945-1960 must be placed in further perspective. Based on *Minerals Yearbook* statistics, the record exhibits reveal the explosive volumetric growth experienced by natural gas sales over the relevant period: in 1935, 1.92 trillion cubic feet; in 1940, 2.66 trillion cubic feet; in 1945, 3.92 trillion cubic feet; in 1950, 6.28 trillion cubic feet; in 1955, 9.41 trillion cubic feet; and, in 1963, 13.88 trillion cubic feet. During this period demand increased over 700 per cent. This growth, when considered with the circumstances that production rates of return on average total capitalization have declined steadily since 1951,[6] and that several large supply areas have developed from what were once considered doubtful prospects, conclusively establish that there is no substance to the proposition that extravagant producer returns resulted in unnecessary exploratory drilling activity during the relevant period. The activity of natural gas production is simply not susceptible to the same precision of cost-control that is possible in most manufacturing and retail operations. Ultimately, unproductive outlays will always be the price of flowing gas, just as flowing gas will always be the product of once doubtful expenditures.

Reflecting a remarkable demand explosion, the high desirability of natural gas as an energy source doubled its relative position in the energy fuels market. Gas supplied but 14.1 per cent of this market in 1946. This increased to 17.6 per cent in 1949, to 20.5 per cent in 1951, to 24.5 per cent in 1954, to 27.6 per cent in

[6] Respondent's Exhibit No. 220, Schedule 11.

1958, and to 29.4 per cent in 1960. While the 1946-1960 rate of growth for coal-lignite and liquid petroleum was a sluggish 2.4 and 4.7 per cent, respectively, natural gas experienced the rapid growth rate of 8.4 per cent.

The effect of this increasing demand on wellhead prices has been thus explained:[7]

> The sharp increase in field prices over the space of a year or so is undoubtedly responsible for much of the political support of price regulation for the industry. Such a rapid rise in prices is, of course, quite possibly compatible with the operation of a competitive market where consumption increases rapidly and where a part of the increase is in higher value uses, as has been shown to be the case in this industry. Total marketed production

> averaged 5.1 trillion cubic feet per year for the country as a whole in the period 1946-1950, compared with 8.8 trillion from 1953-1955, an increase of about 75 per cent, compared with the 86 and 93 per cent increases in price in [Texas Railroad District Number 4 and South Louisiana]. The relative price increases are not appreciably greater than the relative increase in consumption for the nation as a whole, and in these two areas marketed production was probably up more than the national total.

The increasing demand for interstate gas dictated that annual additions not only equal production, but that a reserve cushion also be added as a safety margin. As annual consumption increased, annual findings had to increase at a greater rate. Prices had to rise, not only to

[7] Cookenboo, *op. cit.*, p. 39.

meet rising costs, but also to finance the annual increase in capacity. In other words, prices had to more than recompense the previous investment in order to provide more than current production. The result was the classic reaction of a free market: prices rose, not only to increase capacity in response to demand, but also to limit that demand until deliverability had accelerated.

The price rise has had, and continues to have, two other highly desirable effects upon the disposition of natural gas: it curbed waste, and it deflected gas away from such inferior uses as carbon black production. The record portrays this quite distinct inverse relationship between price and waste:

Year	Average Wellhead Price Seven Southwestern States (¢ per Mcf) Constant (1947-1949) Purchasing Power	Wasted and Vented Seven Southwestern States Per Cent of Net Production
1946	4.1	24.7
1947	3.9	22.7
1948	4.3	15.7
1949	4.5	15.1
1950	4.7	12.2
1951	4.8	10.2
1952	5.6	10.0
1953	6.7	9.1
1954	7.4	7.7
1955	7.6	7.5
1956	7.7	7.6
1957	8.0	6.8
1958	8.7	5.1
1959	9.4	4.4
1960	10.1	4.2

The Bureau of Mines *Minerals Yearbooks* reveal the identical inverse relationship between price and less desirable uses:

Consumption Sources	1940	1945	1950	1955	1963
Residential	16.7	15.6	19.9	23.4	24.5
Commercial	5.1	5.9	6.4	6.4	8.7
Total	21.8	21.5	26.3	30.3	33.2
Oil Field	26.8	23.5	19.7	16.7	14.2
Carbon Black	13.9	11.0	6.8	2.7	.8
Refineries	4.8	8.7	7.6	6.9	5.4
Electric Utilities	6.9	8.4	10.4	12.7	14.6
Other Industrial	25.8	26.9	29.2	30.7	31.8
Total Industrial	78.2	78.5	73.7	69.6	66.8

In evaluating the advisability of placing primary reliance on field-negotiated prices, it is necessary to appreciate that the increase in wellhead prices was but a slight portion of the increase in burner tip prices, and that neither increase was inconsistent with contemporaneous trends. Witness Jordan's exhibit reflects the following relationship between wellhead and burner tip price increases:[8]

Year	Wellhead Prices	Average Value Residential Use	Wellhead Price as a Percent of Residential Value
1950	6.5	69.0	9.4
1951	7.3	76.0	9.6
1952	7.8	83.1	9.4
1953	9.2	86.5	10.6
1954	10.1	89.3	11.3
1955	10.4	88.7	11.7
1956	10.8	91.3	11.8

[8] Respondent's Exhibit No. 42.

Year	Wellhead Prices	Average Value Residential Use	Wellhead Price as a Percent of Residential Value
1957	11.3	93.0	12.2
1958	11.9	98.2	12.1
1959	12.9	101.1	12.8
1960	14.0	103.4	13.5
Increase			
1950-1955	3.9	19.7	19.8
1955-1960	3.6	14.7	24.5
1950-1960	7.5	34.4	21.8

The above clearly establishes that, while the years 1950-1955 saw a 3.9 cent increase in wellhead prices, they also saw a 19.7 cent increase in residential prices. The years 1955-1960 show a similar relationship: a 3.6 cent increase in wellhead prices and a 14.7 cent increase in residential prices. For the entire period, the relationship was 7.5 cents to 34.4 cents, revealing that residential price increases were the result not of wellhead price increases, but, among other things, of increases in the capital costs and expenses of transportation and distribution. The following nationwide figures are important:[9]

DISPOSITION OF CONSUMER PRICES

Average Overall Prices	1954	1957	1960
	Prices (per Mcf)		
Wellhead Value	.10	.11	.14
Value at Point of Consumption	.38	.43	.50

[9] Respondent's Exhibit No. 32, Table 14.

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(277,726)

	1954	1957	1960	
Functional Shares (per Mcf)				
Production	.10	.11	.14	28%
Other	.38	.32	.36	72%
	.38	.43	.50	100%

CHANGES IN CONSUMER PRICES

	1954 to 1957	1954 to 1960
Functional shares (per Mcf)		
Production	+0.01	+0.04
Other	+0.04	+0.08
Total	+0.05	+0.12

These charts are persuasive indicators that producers have not been the cause of "anarchic inflation". To the contrary, the legitimate costs of producing and delivering natural gas have necessarily resulted in price increases which must be borne to the end that a sufficient and assured quantity of gas is available for ultimate users throughout the Nation. Significantly, our opinion today establishes that costs have risen to rates that are no more than is required to provide natural gas service.

The price indices at production and consumption points for various fuels, and a comparison of production point fuel price increases to general indices is conclusive in the cumulative statistical presentation. The record reveals the following:[10]

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[10] Respondent's Exhibit No. 25, Schedule 15.

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Comparative Weighted Average Prices of Mineral Fuels at Points of Production in Cents per million BTU United States

Year	Natural Gas	Crude Oil	Bituminous Coal	Penn. Anth.
1945	4.6	21.0	11.7	23.2
1946	4.9	24.3	13.1	26.9
1947	5.6	33.2	15.9	28.4
1948	6.0	44.8	19.0	31.2
1949	5.9	43.8	18.6	33.0
1950	6.0	43.4	18.5	35.0
1951	6.8	43.6	18.8	37.4
1952	7.2	43.6	18.7	36.9
1953	8.6	46.3	18.8	38.1
1954	9.4	47.9	18.4	33.5
1955	9.7	47.7	17.2	30.9
1956	10.0	48.1	18.4	32.2
1957	10.5	53.2	19.4	35.4
1958	11.1	52.0	18.5	35.0
1959	12.0	52.0	18.2	32.9
1960	13.0	49.7	18.1	Not available

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Annual Indexes of Retail Fuel Prices
(1945 = 100)

Year	Oil Gas Residential Space Heating	No. 2 Fuel Oil	Bituminous Coal	Anthracite Coal
1945	100.0	100.0	100.0	100.0
1946	99.0	100.8	105.3	110.9
1947	100.0	120.2	124.4	120.4
1948	100.9	153.0	148.2	135.2
1949	102.2	145.0	153.6	144.4
1950	102.6	146.6	159.2	150.0
1951	103.6	155.0	162.8	164.5
1952	106.9	158.6	165.9	167.1
1953	112.6	166.8	169.3	178.7
1954	115.8	167.9	169.2	172.0
1955	121.8	173.5	171.0	168.9
1956	122.7	182.0	177.3	177.7
1957	124.0	191.4	184.4	193.1
1958	131.2	180.3	187.1	191.5
1959	135.7	182.8	190.3	189.6
1960	147.2	179.6	191.9	185.3

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These data reflect what has been too-lightly disregarded: that the rise in natural gas prices was not excessive in relation to the rise in interstate demand, the rise in wholesale price trends, the rise in price trends for competitive fuels, or the rise in average hourly earnings. They also reveal that criticism cast on the producer for residential price increases was 80 per cent misplaced, and accusations of extraordinary production returns were statistically unsupported. This overall picture is made clear by the chart on page 24. Rather than constituting a justification for rigid cost-plus regulation, the criticism is refuted by the extensive investigation and cross-examina-

tion that has occurred in this case. It must be concluded that natural gas has been earning no more than a fair return on its costs, and the absence of conclusive evidence to the contrary bolsters the presumption that the competitive factor in the field provides, within limitations, the necessary independent determinant to this Commission's regulatory responsibilities.

The absence of producer price-dictation in the Permian Basin

The early necessity for conservation laws in most states was a result of the ruinous competition that was possible in producing fields because of the law of capture. This era of active rivalry among producers is now past, but the opportunity for independent operation which led to state conservation regulation indicates the sense of independence that is common among the operators of producing properties. It is indeed fortunate that these early predatory practices have been eliminated. Furthermore, the prevention of drainage to protect correlative rights and the regulation of production to reflect market demand has not eliminated competition in other aspects of the companies' activities. The primary basis that leads to any presumption of a lack of competition has been the price rise. As discussed earlier, this has been no more than a reasonable rise responsive to high costs, and it was considerably less marked than the increases which resulted in other commodity-oriented industries.

Aside from the overwhelming concentration on costs by Staff and the California distributors, thorough con-

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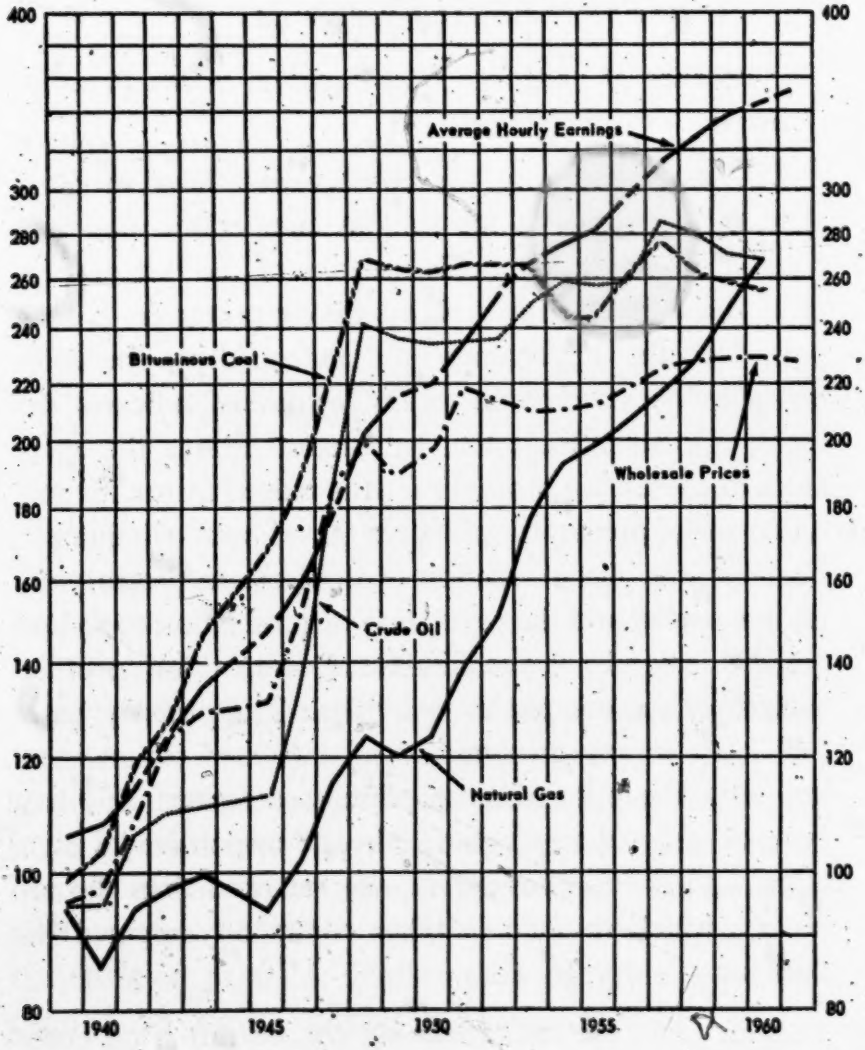
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COMPARATIVE TRENDS OF AVERAGE PRICES OF MINERAL FUELS AT POINTS OF PRODUCTION

United States

1939-1961

INDEX NUMBERS 1935-1939 = 100



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sideration of the competition issue has been clouded in a failure to make precise definitions. The problems of description and categorization result from the various meanings attached to the concept of competition. In my view competition means a buyer is free to purchase alternative sources of a product from relatively small sellers acting independently of each other.

However, in addition to the price rise emphasis, certain parties improperly assume monopolistic motivations. This assumption necessarily rests on the classical model of only two sellers of equal power; it thereby overlooks the environment in which enterprise operates: that of sellers of different size subject to a multitude of economic conditions, all of which combine to make any final price the subject of numerous considerations which regulators can at best estimate. More evidence is needed than a restricted competitive model. Consideration must be given to relative size, to numbers of companies, to ability to enter the market, to any business arrangements between various sellers and buyers, and to the countless other factors that make up a market. Of particular

significance to the producing industry are such special market conditions as acreage controls, flaring rules, and the prevention of lapse of the lease. The question is one of the power of a seller or group of sellers to dictate a price that is divorced from costs. This condition does not exist in the Permian Basin. It is clear that there is such a measure of effective competition that in future proceedings producers can be accorded a relative degree of independence to the end that contract prices determine the ceiling price we set for natural gas.

On the record before us, there is no evidence of monopolistic power possessed by producers in the Permian Basin. The issue, though properly raised by the producers, has gone unnoticed by the other parties. Respondents have met the burden of proof on the competition issue. Staff and the California intervenors have not. The state of the record is such that Respondents have made every possible showing of competition, and, further, they have shown that this competition is sufficient, under a majority of the contracts, to provide a meaningful methodology for determination of just and reasonable rates. It is no answer to say that the producing industry has not met its burden. The burden of proof is not solely on Respondents. Although this proceeding involves Section 4(e), filings, where the burden is expressly placed on producers, it is essentially a Section 5(a) proceeding in which our Staff must make the proper showing. Nevertheless, this case cannot turn on the burden of proof. There is sufficient evidence on all issues.

Furthermore, that this is a regulatory proceeding does not detract from thorough consideration of relevant economic evidence to ascertain whether producers exercise undue powers over price. Certainly there is no basis for a presumption that there is no competition. The ramifications of the order we issue today require comprehensive and meaningful treatment of this issue.

Briefly, the record shows that, of all producers in the Permian, 361 were named in the order initiating this proceeding, but no one of these sells over eight per cent of the gas produced on a national basis. In addition, at least 2,280 producers in the Permian Basin supply gas to processing plants under percentage contracts. In the aggregate, there were 54 producers in 1960 who sold over ten million Mcf of gas per year. In the Permian Basin there are 20 producers selling some 80% of the gas produced. These numbers and sizes necessarily raise the presumption that there is such a degree of self-interested rivalry and of independent action as to preclude a presumption of concerted action. On the other hand, there is not a scintilla of evidence that any of the producers have ever acted collusively; they have not exercised their power in a manner harmful to the competitive market. There has been no parallelism in prices to indicate action by any producers to

control price. This stands out clearly:[11]

Year	Company	Number of Contracts	Price Range
1953	El Paso Natural Gas	45	9.0¢-10.0¢
1954	El Paso Natural Gas	80	8.5¢-10.0¢
	Permian Basin Pipeline (Northern Natural Gas)	6	9.0¢-10.5¢
1955	El Paso Natural Gas	32	8.5¢-10.0¢
	Northern Natural Gas	2	9.5¢-15.0¢
1956	El Paso Natural Gas	47	7.5¢-10.0¢
	Pioneer Gathering System	1	11.0¢
1957	El Paso Natural Gas	36	9.5¢-11.0¢
	Northern Natural Gas	7	9.5¢-16.0¢
	West Texas Gathering Co.	15	16.0¢
1958	El Paso Natural Gas	34	10.5¢-11.0¢
	Northern Natural Gas	1	9.5¢
	Transwestern	10	16.0¢-22.0¢
	Pioneer Gathering System	9	10.0¢-12.5¢
	West Texas Gathering Co.	2	16.0¢
1959	El Paso Natural Gas Co.	24	9.0¢-11.0¢
		407	14.5¢-17.0¢ (renegotiated)
	Northern Natural Gas Co.	3	13.5¢
	Transwestern	12	16.0¢-22.0¢
	Pioneer Gathering	2	12.5¢
	West Texas Gathering	5	16.0¢
1960	El Paso Natural Gas	19	10.5¢-17.0¢
		15	15.0¢-17.0¢ (renegotiated)
	Northern Natural Gas	1	13.5¢
	Transwestern	23	15.5¢-22.0¢
	West Texas Gathering	5	16.0¢

[11] Respondent's Exhibit No. 25, Schedules 12 and 13.

Such a vast range in prices over the period of almost a decade certainly is suggestive of the fact that all producers, or even the major sellers do not exercise effective monopoly powers.

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There is relative ease of entry into the business. Such discrimination as may exist comes, not from producers, but pipelines. Further, it must be emphasized that such factors as a rapid growth rate, excess capacity, and meeting the prices of a rival are conditions to be expected in a market that is rapidly expanding and coming into its own. The opening of markets and the high rate of technical progress usually characteristic of such a situation make for uncertainty as to the most profitable policies. Any uncertainty of prices under contracts, even when Transwestern broke El Paso's monopoly, reflects no more than unprecedented demand and not monopoly control by producers.

The sole non-competitive factor has been the long-term contract, required by this Commission as a condition precedent to certification. Early uncertainty as to the proper prices for natural gas and particularly its use as a waste product acerbated this twenty-year pricing policy by compelling producers to insist on various indefinite escalation clauses to the end that, once stable prices were realized at a level that returned costs to the producer, each seller would so benefit. These clauses have been negotiated in the Permian since at least 1945 when El Paso contracted with Phillips for a sale of gas

at 3.5¢ per Mcf, but subject to indefinite escalation based upon El Paso's resale rates at the California border. Since the middle of the last decade, such indefinite escalations have been uniformly condemned. The following comment is relevant:[12]

> Many witnesses appearing before the committee, particularly those representing distributing interests and consumer areas, maintained that escalation clauses in existing contracts, unless their operation is controlled in some effective manner, could result in very large increases in the cost of gas to consumers —
>
> **277,733**
>
> particularly in view of the fact that a contract for natural gas usually runs for 20 years or more, and a large proportion of the contracts presently in effect were entered into in recent years . . .
>
> It is provided . . . that where a rate increase is based on a price increase resulting from the operation of an escalation clause [except the so-called step-up and tax-increase clauses] in an existing contract the Commission may not consider as an operating expense for the purchase of such natural gas any part of the increase in price which results in a price in excess of the reasonable market price therefore.

We have endorsed the above recommendation by prohibiting the prospective operation of such clauses.[13] Our

[12] Report of the Committee on Interstate and Foreign Commerce; to amend the Natural Gas Act, as amended; House Report 992, p. 9 (84th Congress, 1st Session, 1955).

[13] See the *Pure Oil Company*, 25 FPC 383 (1961); Order Nos. 232 and 232-A, 25 FPC 379, 609 (1961), amending Sections 154.91(a) and 154.93 of the Commission's Regulations under the Natural Gas Act.

opinion today permits their further operation only to the extent they were negotiated in past periods and in any event such escalations cannot exceed the ceiling rates. Looking to the future the extensive impact of limited price increases in new contracts cannot approach the increases realized in the last decade. Thus, by this determination, there is a solution to the single factor that has compromised workable competition.

Finally, in determining the competition issue, it is relevant to consider an energy market broader than the natural gas industry of the Permian Basin. It is clear that natural gas is presently sold at a level competitive with other fuels and sources of energy. This is particularly the case on a national basis, and is the result of continuing economies in the coal and electric industries. If our analysis is expanded beyond the Permian to take cognizance of this national energy market, there is evidence of those conditions that would indicate restrictive economic forces. There are alternative energy sources to provide an independent

determinative of prices. The consumer's individual outlay does not restrict his freedom to select alternative sources; the energy market is in a state of equilibrium. For this reason, if no other, transmission companies cannot disregard the prices paid to producers, and, particularly for the future, it cannot be assumed that the pipelines do not have the same interest in their investment as the distributors have in their related investment.

Reliance on the price rise to justify a conclusion of producer price-dictation must falter in the face of overwhelming evidence that this rise was parallel to the rise in all other price indices, that the price rise reflected the elevation in the value of natural gas to a level that would return to the producer his reasonable costs, and that there is competition sufficient for our regulatory purposes. For these reasons, I rely upon the reasonable market prices in addition to the cost considerations in our decision.

JUST AND REASONABLE RATES BASED ON CONTRACTS

Far from undercutting our power to impose effective price ceilings, a price-demand approach would retain flexibility and would still present a direct relationship between cost considerations and the price ceiling. In view of the cost presentation herein, it appears that in the future reliance on competitive forces should be sufficient. The independent operation of substantial parts of the market will provide an average price accommodating to the mandate that controls be imposed upon prices for natural gas. To the extent possible, one part of an essentially joint product will be regulated in a manner responsive to the needs of both the industry and the consumer. So long as most producers can operate under a compulsory price ceiling, the supplies will be available, and by that ceiling the consumer will be protected from price escalations that are not acceptable. The question becomes one of methodology. Although it might be preferable to enact legislation to abandon any effort at

price control other than such reasonable restraints as might be imposed upon pipelines, such limited controls are not totally removed from a method that has proven successful in the last few years.

Relevance of our in-line pricing policies

Following the Supreme Court's mandate in *Atlantic Refining Company* v. *F.P.C.* (*CATCO*), 360 U.S. 378 (1959), the Commission has followed a course in Section 7 proceedings of fixing ceilings at reasonable rates relevant to the existing market. It has thereby centered its attention on the weighted average prices under contracts which provide for the sale of substantial volumes of natural gas in interstate commerce. Indefinite escalation provisions have been removed, and rate increase moratoria have been imposed. Attention has been directed to permanent and temporary certificates covering contract rates, and the Commission has strenuously resisted all attempts to interject cost presentations submitted on an individual company basis. It has thus been successful

in effectuating, simply, quickly, and with minimal disruption, what five years of agitation and uncertainty, fraught with numerous procedural disruptions, can scarcely improve upon: fixed rates that are sufficiently high to induce adequate reserve accretions and yet with provisions for rate increases that would be so gradual that any unpredictable economic disruption at the distribution end of the natural gas industry would be precluded. Al-

though the procedure was notably unrefined, it has likewise proven to be remarkably efficacious. The in-line procedure took the notable step of avoiding cost-plus producer regulation and thereby illustrated that a "sane, sensical, and effective" course to producer regulation was available. Significantly, it represented initial development of the policies we adopt today. Nevertheless, since in-line proceedings arise under Section 7, it is appropriate that there be a more thorough analysis of contract prices when consideration is given the standards of Sections 5(a) and 4(e). Thus, the Ninth Circuit has stated that the provisions of Section 7 for certificates of public convenience and necessity do "not mean that before certificating such a sale the Commission must determine that the proposed initial price is just and reasonable [by Section 5(a) and 4(e)]." *United Gas Improvement Co.* v. *F.P.C.*, 283 F.2d 817, 822 (9th Cir. 1961).

The record in this case provides substantial evidence that in the future we should perfect a system of producer regulation that considers costs, but relies on the competitive forces, which in themselves provide an independent determinant to prices apart from what producers might prefer to dictate. Thus, the logical focus of producer regulation on an area basis lies in the negotiated field contracts. They are executed under circumstances of market compulsion after full consideration by persons intimately associated with the industry of all the factors that a regulatory agency can only estimate. These contract prices provide a privately-litigated answer to the question of what rates will be necessary to get the gas out of the ground. Any meaningfull system of regula-

tion would appraise the level of these prices as determined by arm's length bargaining in a competitive market. The analysis should include intrastate prices for that market will provide useful information for comparative purposes. While it is to be expected that regulation will distort a competitive market, contracts continue to be negotiated above these ceilings, and in-line price conditions are refused by producers in favor of other markets. Finally, since costs now approximate revenues, it should follow that competitive prices would accordingly be in-line.

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The focus on contracts would remain constant unless there were important departures in direct relation to current experiences and projections of production volumes, exploration and development expenditures, drilling success ratios, market demand reserve additions, and the general cost indicia of the national economy. Of these several economic indicia, the single most important one is the reserves added each year. This is the crucial measure of the ability of just and reasonable rates to elicit the necessary supply. For present purposes it is apparent that field negotiations have been successful in eliciting supply, and that no specific reserves to production ratio should be required. The other important economic indicia are exploration and development expenditures and drilling success ratios. Both are joint costs of the oil and gas industry, but substantial deviations of either over the long term will require corresponding rate adjustments. Necessarily, both relate to the supply

elicited. It is these relationships that can best assist us in a determination of whether regulatory controls are successful in meeting current and projected needs. If adequate reserves were being elicited, an uncomplicated, practical decision would be one which imposed a single ceiling approximating the initial price mode or median of new contracts. If additions were excessive, based on current ratios, the ceiling could be lowered to inhibit exploration and dedication of further volumes to interstate commerce. If additions were deficient, the single ceiling would be adjusted proportionately upward, and, if the reserve posture required even more drastic remedies, contract rates could be increased upward pursuant to Section 5(a) as construed in *F.P.C.* v. *Sierra Pacific Power Co.*, 350 U.S. 348 (1956). Finally, if specific rates were unduly discriminatory or preferential in specific cases they could be adjusted within the purport of just and reasonable rates.

Such a policy could be implemented with a maximum of time and expense. The regulatory burden would be greatly relieved, and Federal expenses would concomitantly be reduced. Although an orderly conclusion of pending area rate cases is presently required, contracts should provide an expeditious basis for setting just and reasonable rates in all other producing areas. Ancillary benefits would follow as cost-plus thinking is de-emphasized. More meaningful reserve data would be obtained. Difficult allocations could be of more limited impact. Cost questionnaires, indicative of whether trends in wellhead prices were approximating general indices,

would be far more simple and consequently far less expensive to complete. Since prices would be established expeditiously, they would be maintained current without resort to figures and testimony that are five years old. This would be achieved in addition to our current policy, clearly the most consumer-conscious yet effected, of imposing increased limitations to maintain current prices with provisions for filing for moderate increases in accordance with market determinations and other general economic trends.

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The Reasonable Market Prices:

Subject to these additional views on the course we should take in establishing just and reasonable area rates for the Permian Basin, I concur fully in the Commission's opinion. Our opinion establishes that profit-oriented costs and supply oriented contracts do not, in the aggregate, depart in any significant manner from each other. To the contrary, an analysis of market prices establishes that contracts have apparently approached costs for the natural gas industry in the Permian, and, for the past few years, have maintained a level close to the cost analysis we here adopt. This is a significant stabilization. Thereby, a market price has been established which provides a reasonable measure of the rate necessary to elicit supply. From the record in this proceeding, for the period with which we are concerned, the overwhelming volumes of gas-well gas are sold under new contracts at the weighted average price of approximately 16.5¢. Con-

sidering this close proximity of the contract average to composite costs, it is clear that, by either standard, the rates we prescribe for the Permian Basin are just and reasonable.

The record establishes that, for all filed contracts in a seven-year period before and after 1960, there was a range in prices from 2.15 to 18.0¢.[14] The weighted average price for these contracts, based on volume, was 14.20¢ for 1962. This price is based on the initial contract price, and it is not shown what adjustments, if any, were provided for quality, taxes, and other circumstances. These have a definite impact on the regulatory rate we must establish. More particularly, as of early 1962, approximately one-half of the volumes sold was at an upward range from 15.0¢ to 17.0¢. Under various periodic escalations this price could be increased, by the end of 1968, to a price ranging from 16.0¢ to 18.0¢, with the overwhelming volumes being sold at prices approaching 18.0¢. Since we here intend price control up to an earlier date, Respondent's contract testimony is commensurate with the just and reasonable rate for the period. Other testimony establishes that, for contracts dated subsequent to 1960 but prior to the middle of 1963, the base prices range from 9.0¢ to 17.0¢ for gas-well gas, with the larger volumes flowing at rates ranging from 15.5¢ to 17.0¢ with the largest volumes at 16.0¢.[15] Based upon this survey of base prices under contracts, some as reduced under certificate conditions and accepted

[14] Respondent's Exhibit No. 252.

[15] Staff's Exhibit No. 317A.

by producers, the 16.5¢ rate established by our cost analysis is clearly within the range of contract prices.

There are limitations in relying solely on the above evidence, primarily because various adjustments for deviations from the standards for pipeline gas are not necessarily reflected in the contract price for new gas-well gas. The weighted average contract price for gas-well gas is 14.76¢, apparently after certain proportionate adjustments to reflect deficiencies.[16] Among others, these deficiencies include excessive sulphur and hydrogen sulfide content, excessive water content, below

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standard pressure, and excessive carbon dioxide in the gas. From the record it appears that the possible range for specific adjustments will be from three to five cents; however, for all adjustments that might be necessary, the reasonable amount of the average adjustment will be in a range of from 1.0¢ to 1.7¢.[17] Adding this adjustment to the average weighted price of 14.76¢ a ceiling is indicated of from 16.0¢ to just below 16.5¢. In accordance with a policy of rounding upward, this would mean that a price of 16.5¢ is the just and reasonable rate for new gas well gas.

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[16] Staff's Exhibit No. 334.

[17] A precise adjustment for quality cannot be ascertained from the contract exhibits in this proceeding. The Examiner made a general determination that one cent would be appropriate. See Examiner's Decision, pp. 69-73. Subject to developments under the quality adjustment procedures, we establish, the range is presently appropriate.

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Further analysis of the record evidence supports the above conclusion.[18] Since the contract prices must be considered in the light of the quality of gas sold, it appears clear that, of the limited volumes of gas sold at pipeline quality standards, the 16.5¢ rate is clearly in line. The highest price for new gas-well gas is 17.0¢, which was paid for an estimated annual volume of 2,126,400 Mcf under six rate schedules. All of this gas appears to meet pipeline quality standards, except for 180,000 Mcf of gas sold under one contract allowing a lower Btu content and containing no specification as to water content. A larger quantity of new gas-well gas was sold at 16.0¢ — 6,149,336 Mcf to El Paso, 9,751,680 Mcf to Transwestern, 2,444,772 Mcf to Northern, and 958,320 Mcf to West Texas Gathering Company. All contracts for sales to West Texas Gathering Company would allow delivery of "sour" gas. The 16.0¢ price might have been higher had the gas been required to be of pipeline quality. These contracts are silent with respect to water content. Contracts governing the 2,444,772 Mcf sold to Northern provided for a minimum Btu content ranging between 950 and 1,000 and had no provision with respect to water content. These contract provisions do not reveal the actual quality of gas delivered, but again it appears that the 16.0¢ price would probably have been higher for higher quality gas. It is indicated that a 16.0¢ price paid by Transwestern was negotiated despite variations in the quality of the gas. Some 420,000 Mcf sold under three contracts is subject

[18] Staff's Exhibit No. 334.

to contract provisions requiring that the gas meet all pipeline quality standards save that the contract is silent with respect to water. The actual water content of the gas delivered cannot be determined. The remainder of the gas appears to be below standard in either pressure or in hydrogen sulphide content. Some 1,108,000 Mcf of this gas may also be deficient in Btu content, and about 6,475,000 Mcf of this gas moves under contracts which provide no standard with respect to water. The El Paso contracts at 16.0¢ are uniform in fixing delivery pressure at 1,000 pounds but are silent on most of the other quality standards.

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At the contract price of 15.0¢, estimated annual volumes of 8,433,048 Mcf of new gas-well gas were sold to El Paso and 2,007,324 Mcf to Northern. The 26 El Paso contracts at this level are, with two exceptions, silent as to water content. Eleven of them require pipeline standards with respect to sulphur and hydrogen sulphide. One is silent on this subject, and the remaining 14, totaling nearly 3.5 million Mcf, do not require pipeline standards with respect to sulphur. Pressure appears to be below pipeline standards in the case of the majority of the 15.0¢ gas sold to El Paso, and possible Btu content deficiencies are indicated with respect to about one-third of this gas. The three contracts at 15.0¢ for sale of new gas-well gas to Northern provide for pipeline quality standards in all respects save that no standard was provided with respect to water content. Again we have no

information as to the actual water content of the gas delivered. From the above it must be concluded that new gas-well gas delivered at prices below 15.0¢ is, from the record before us, deficient with respect to one or more quality standards.

Attention should be called to the fact that the prices set forth in this exhibit are not for all the market sales of gas in the Permian Basin Area. No information was included in this record as to particular non-jurisdictional sales although some attempt was made by the Staff to show that the average non-jurisdictional prices were lower than jurisdictional prices. I emphasize that such intrastate conditions of the market are relevant considerations to area pricing. Taking all these factors into consideration upon the evidence presented, it must be concluded that our price of 16.5¢ set for new gas-well gas is appropriate; therefore, a just and reasonable rate is established.

Despite the validity of the 15.5¢ base price (exclusive of State taxes) for new gas-well gas, it is not acceptable to the extent that there is not a full upward adjustment for high Btu content.

It is clear that the quality of a particular volume of natural gas has a definite impact on the value we should assign to that gas. Consumers are interested, not in Mcf's, but in the heating units derived therefrom. For variations from what is required to supply consumers adequate therms of gas, there should be proportionate adjustments. On the basis of the record before us it is a matter that is not readily susceptible to resolution, and,

to determine the full extent of the adjustments that might be necessary, we have ordered procedures for negotiation of these matters.

It appears that natural gas from the Permian Basin is generally deficient in many of the standards required for pipeline quality as we have proposed in R-200, noticed at 18 FR 2.60, 2.61 (1961). A large amount of sour gas is found, there are several fields with large amounts of carbon dioxide, and low pressures are common. These deficiencies are to be reflected in downward adjustments from our base prices. On the other hand,

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Permian gas does have one quality — Btu content — that is apparently higher than is delivered to pipelines in other producing areas. I dissent from the anomalous position of requiring full downward adjustments for all quality deficiencies while denying to producers a right to obtain meaningful upward adjustment for the single quality standard that is above pipeline quality. I emphasize that this dual standard attacks the validity of our cost analysis since, absent proper upward adjustments, it is possible that producers will not recover their legitimate costs.

In our recent decision in *Texaco Inc.*, Opinion No. 464 (issued June 10, 1965), we determined that, for the Hugoton-Anadarko producing areas, 1000 Btu's was the standard for pipeline quality there. Significantly, we relied on the contract terms, although Staff had favored

a weighted average base of approximately 1020 Btu's. It is appropriate to adopt area standards, but this being an area proceeding, all relevant circumstances should be considered. It is far from clear that the area standard for new gas-well gas is at 1050 Btu's. The weighted average for new gas-well gas is 1042, but this average is derived by excluding carbon dioxide volumes; if the latter are included the weighted average is lowered to 1034 or lower. Furthermore, it should be noted that the weighted average for all gas flowing in 1960 appears to be at 1039 Btu's. If our attention is directed to the contract requirements of the pipelines, which is the standard for determining all the quality deficiencies, it is clear that the minimum required is 1000 Btu's or lower. The standard Btu provision imposed by the transmission companies for purposes of price adjustments or rejection is between 1000 and 950 Btu's, but the preponderance of the contracts requires 1000. The opinion is thereby left with an obvious gap of 50 Btu's by which producers are denied the benefits of the gas they sell. If we compare the area standard with the national standard, it is clearly at 1000 Btu's, as we have proposed in R-200. Finally, it appears that the 50 Btu gap is important solely to the California distributors as a result of the high Btu content in the gas delivered to them at the California border. The reasons for this high standard are not known; certainly no producer participated in the negotiations leading to these sales. Rather than approve a practice of unknown origin, I would rely on the uniform contract standard for the Permian area, for the Nation, and for our proposed R-200

to set an upward adjustment from 1000 Btu's for new gas-well gas.

There are major difficulties in basing regulation on contracts while adopting the directionality thesis. Under price-demand split-level pricing should be avoided. In addition, since the natural gas industry generates a large portion of its own capital, it thereby underwrites current exploration by the older production. Reinvestment is an accepted and necessary feature of the industry, and the revenues it receives must be a source of funds for continued and increased nationwide exploration and development. We can be assured that the needed gas will not be found unless we acknowledge a proper role to reinvestment. This conclusion is particularly compelling during a transition to effective just and reasonable rates. We must condition our determination today to developments under a two-price system. Directionality is presently acceptable as an exploratory device of the industry. Because of the variance in elasticity between casinghead gas and gas-well gas, price can be utilized as a device to elicit supply; however, such regulation must be premised on a two-price system to reflect

market conditions. In these circumstances, the selection of a dividing line between old and new production can be made. In view of the necessary role of reinvestment and of the long pendency of these proceedings, the division date should be drawn between the years when reinvestment was the sole reliance and when directionality had

begun to establish itself. Since this had occurred by 1960, I accordingly join in the division date for old and new gas. For the test year, the weighted average price for all flowing gas-well gas was below 14.5¢. Again, the record is deficient as to the quality of this gas. The record does establish that the weighted average revenues received for all gas-well gas flowing in 1960 was 13.05¢.[19] Applying an appropriate upward adjustment for quality deficiencies a price in the range of 14.0¢ to 14.5¢ is established. It is noted that this is a different standard for determining a price for old gas-well gas than for new. Nevertheless, it is an appropriate standard for determining a regulatory rate reflecting the price at which a majority of producers are able and willing to sell gas for a period encompassing several years during which costs were apparently being recovered. This is offset by the less demanding standard required for new gas-well gas to the end that an appropriate incentive is utilized. Further, the 14.5¢ ceiling applies to new casinghead gas and to residue gas from non-gas-well gas reservoirs. This reflects the relative inelasticity of those types of gas. Therefore, it can be concluded on the present record that the cost-plus rate of 14.5¢ for flowing gas is the just and reasonable rate, and I accordingly support the rate design prescribed. For future proceedings our opinion should lend support to this simpler and more realistic approach.

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[19] Staff Exhibit No. 175, Schedule No. 1. It should be noted that the average initial price for gas-well gas sold in 1960 is 13.2¢. See Staff Exhibit No. 118.

It follows from my dissent as to the appropriate Btu standard that I also dissent from the determination to permit an upward Btu adjustment only for new gas-well gas. The fact that tremendous volumes of high Btu content gas are sold in residue gas, in casinghead gas, and in old gas-well gas is not considered, although our quality standards otherwise apply to all types of gas. I cannot condone this discriminatory determination. Upward Btu adjustment from a base of 1000 should be applied to all gas from the Permian Basin. I would note that the additional revenues to the producers as a result of the 1050 standard will apparently be so minimal as to be meaningless. The better course would be to avoid any standard pending developments under the quality adjustment procedures.

Although I believe a more complete discussion of just and reasonable market prices should have been added to supplement the reliance solely on cost-plus, I support the rationale in the main opinion. The cost analysis there employed is not only reasonable; more important, it is a feasible synthesis of the cost evidence before us. Such costs are most useful as a basis for comparison to the contract prices. Our proceeding has established a significant point: there is no substantial difference between market and costs in the Permian. Either method is presently permissible

for purposes of area ratemaking. Accordingly, with the single exception of the Btu standard, I join in the procedures recommended for applying and enforcing the prices determined here today.

/s/ L. J. O'CONNOR, JR.
L. J. O'CONNOR, JR., Commissioner

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Area Rate Proceeding Claude E. Aikman, *et al.* North Central Oil Corporation (Operator), *et al.*	*Docket Nos.* AR61-1 G-18466, *et al.* CI60-435, *et al.*

(Issued August 5, 1965)

ROSS, Commissioner, *concurring and dissenting on limited issue:*

The instant decision represents, in my opinion, a noteworthy advance toward the goal of effective producer regulation and one which, with but one exception, I fully support. In addition to the Examiner and the parties, we are indeed indebted to our Staff and our predecessors on the Commission for their ingenuity in suggesting the concept of the area approach and for beginning this case.

The decision properly recognizes that the basic purpose of the Commission's rate regulation is to assure for the consumers of this nation an adequate supply of gas at reasonable prices. In the course of developing a methodology to meet this objective the majority significantly expresses a flexible and receptive attitude towards

certain issues that were not adequately developed by the parties in this first attempt at area producer regulation, notably capitalization of E & D costs and the usefulness of econometric presentations. My principal purpose in writing this separate statement is to emphasize and focus attention on the changes forecast by the majority, and to suggest future potential refinements in both the methodology and basic data.

While the decision is essentially sound, there can be little dispute that the margin of error will be narrowed as more complete and meaningful data are made available. Surely regulators should not be expected to vouch for absolute accuracy of their predictions without comprehensive and comprehensible gas reserve information.

Since the advent of electronic computers, econometrics has become increasingly useful in many fields as a tool for analyzing complicated economic problems. For the first time in a proceeding before this Commission, an attempt was made to analyze and test the complex interaction of regulatory and market factors with the aid of such advanced statistical and mathematical techniques. The Staff's econometric studies, commonly referred to as the Wein model, were a commendable effort to clarify the supply-eliciting function of natural gas field prices. This is one of the strongly contested and critical issues in this proceeding. The producers, drawing mainly on an analogy with unregulated competitive markets, argued that higher gas prices will elicit larger supplies. The Staff, on the other hand, stressed the inherent limitation on the industry's ability to respond to change in gas prices.

According to the Staff's presentation, the economic determinants of future gas supply include not only the price of gas, which is being fixed in this proceeding, but also various other factors such as the determinants of market demand, the price of oil, and the success ratio in exploratory drilling.

One valuable feature of the Staff's studies is the attempt to identify and quantify both the direct incentive effect of price on exploratory activity and the indirect "feedback" effects on supply due to the price elasticity of gas demand under conditions of interfuel competition in the market place. These opposing effects, as well as the independent effect of oil prices on exploratory activity, cannot be assessed profitably in the abstract, i.e., by gut reaction, but should be quantified, if at all possible, in the interest of more informed regulation under the Natural Gas Act. An example of this questioning attitude is Staff's refusal to accept automatically the proposition that the supply-eliciting function of price in unregulated competitive markets, where price is the result of the push and pull of impersonal market forces, is duplicated in the gas producing industry.

In the long run, I am confident that such analyses will provide fresh insights into the behavior of natural gas supply. I am also confident that this modern economic tool, as it becomes better known, will be adopted by the industry for its own use. Inevitably, this will result in a better understanding of the industry both for the manager, the regulator and the consumer.

In view of the fact that directionality with a two price system has been accepted by the Commission, it is inappropriate for this reason alone to use the results of Staff's studies. Their usefulness in the context of this case has been to cause everyone to wonder about and question the heretofore unchallenged hypotheses of the petroleum industry. When better developed, I am sure the results will provide both a practical and *legal* foundation for better gas producer regulation. I am therefore looking forward to the continuing use and refinement of the application of econometric and other advanced analytical techniques to the difficult task of producer regulation in future proceedings. Surely we should strive for more objective evaluation of economic matters in contrast to relying on our "feel" in such situations.

In view of the basic approach adopted in the decision, the desirability of establishing future area rates in the context of a nation-wide proceeding — from both an economic and administrative standpoint — is strikingly confirmed. The price for new gas is based entirely on a nation-wide rationale and on nation-wide data. This same

basis is used to support the price determined for all other gas. As the decision concludes, the search for gas is conducted on a national basis. This is true not only with respect to producers but increasingly regarding the pipelines as well. The evaluation of location on price, the importance of which the decision affirms, can be determined much more effectively — if not exclusively — in

a proceeding which considers the interrelationships of the various areas of supply with the markets they serve.

From a purely administrative point of view, a nationwide proceeding is a practical necessity. This marks only the first area case, which covers three producing areas. At this time final decisions in the three pending area cases involving eight producing areas are far from imminent; yet a further consideration of Permian rates will be due in a relatively brief two and one-half years. At this rate of progress, a review of Southern Louisiana rates could be due even before the Hugoton-Anadarko cases are concluded. It is easy to see that the Commission could well become involved in the determination and redetermination of the rates for but a fraction of the producing areas in the country, and never complete the job of determining the rates for all of the producing areas. Either this will be the result, or the Commission as well as the industry and other interested parties will be required to add tremendously to their staffs.

Considering area rates within the framework of a national proceeding would also obviate the necessity of plowing the same old ground time and time and time again. Area proceedings involve substantial time and cost not only for the parties but also for the Commission and its staff. While separate area proceedings have advantages for the first couple of cases, the law of diminishing returns rapidly takes over.

Another aspect of our decision which is ripe for further consideration concerns a method of pricing new gas, com-

monly referred to as project accounting. This method visualizes a project consisting of the finding of a given volume of non-associated gas reserves by the drilling effort in a specific test year (e.g., 1960) and the subsequent production of that gas over an assumed depletion period. All necessary outlays to acquire the capital assets (i.e., the reserves), together with an appropriate return on the investment over its productive life, are assumed to be recovered through the revenues traceable to the initial investment. Cash production expenses related to the lifting of the gas to the wellhead are also estimated and added to the investment charges to arrive at a total cost per Mcf to be recouped on a unit-of-production basis over the depletion period. This cost model, which capitalizes all investment outlays relating to the acquisition of the asset and then

allows a return thereon during its period of commitment, requires what is sometimes called a "true yield". The a ceptable method of determining such a rate is an investor-demand type of study focusing on the "capital attraction" rate or the experienced cost of borrowing in the capital market. This is the rate of return standard that is commonly applied by the Commission in regulating natural gas pipelines and electric utilities.

This method can be compared with that employed by the Examiner and adopted by the Commission which is probably best characterized as a form of cross-section accounting. Under the latter method, the costs are esti-

mated for the volumes produced in a given year, assuming equal production from a universe of gas producing properties equally distributed by vintages (thus cross-cutting all vintage projects). Further, under a convention of accounting in the petroleum producing industry, but without logic in economic costing, the cost model of the distributors capitalizes only the costs directly associated with productive properties, which is only a portion of the total cash outlays made in acquisition of the reserves. Outlays for dry holes and other expenditures not directly associated with successful properties are presumed to be expensed in the year of outlay, rather than to be recovered in future years from the revenues of producing properties discovered in the course of a general exploratory effort. Thus, E & D expenses, not related to the production or output of the given year, are substituted for those E & D outlays of previous years which were incurred in connection with the successful exploratory efforts and recouped in the given year when the reserves are being produced. Cash production expense, depreciation, depletion, and amortization expenses, and a return on investment computed on a cross-section basis are also charged on a unit-of-production basis.

In selecting a cost model for new-gas well gas, consideration must be given to the fundamental character of the economic costing problem. Unit costs of production for any commodity or service can only be arrived at by a careful matching of all necessary inputs with the associated output. This matching must, because of the time value of money, adequately reflect the timing as well

as the cost of all inputs. Inputs allowed must strictly relate causally to the output and all such inputs, with their timing, must be fully represented. The project method of accounting meets this basic requirement. In contrast, the other method expenses the portion of the capital outlays which relates to unproductive properties as if they were current operating costs, even though that portion is inseparable, at the initial planning stage, from the successful E & D outlays. Such expensing practices can lead to a distortion of the investors' allowed return from revenues generated by the initial investment.

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In addition, an ancillary benefit of the project method lies in the fact that the somewhat discomforting aspect of "Adjustment for Exploration in Excess of Production", which seems to charge current rate payers for additions to a company's capital assets, is avoided.

This costing approach of capitalizing unsuccessful as well as successful well costs has substantial support within the accounting profession. Arthur Andersen & Co. has enunciated this position clearly and forcefully:

> "The purpose of exploratory activity is to discover oil and gas reserves for future use. Discoveries, however, are unlikely without the incurrence of some exploration costs for unsuccessful ventures. Such costs are necessary in the search for and discovery of new deposits of oil and gas reserves. Exploration costs for unsuccessful ventures are as much a part of the cost of the oil and gas discovered and produced as are the direct costs of productive wells.

"Only a portion of the oil and gas reserves discovered is likely to be produced and sold in a given year. The matching of related costs and revenues logically requires that the portion of all costs, including exploration costs, applicable to the oil and gas currently produced be charged to expense in the period of production.

"Because of the hazardous and speculative nature of the oil and gas industry, most companies have expensed their exploration costs as incurred. This practice has ignored the real capital nature of these costs, and has resulted in financial statements that do not show the total cost of the oil and gas reserves or of the current production therefrom. When exploration costs are charged to expense as incurred, profits are reduced or losses are shown in the exploratory years, because a substantial portion of the costs then being charged off does not relate to the income of the current period but to the income to be derived from future production of oil or gas."[1]

In addition, an excerpt from *Asset Accounting*, by William A. Paton, 1952 edition (pages 440 and 441) states as follows:

"In developing a wasting asset the costs of all explorations may be capitalized, even if some specific operations don't pan out, as long as the program is being carried on in a reasonable manner in the light of prevailing standards and techniques.

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In the development of an oil lease, for example, several dry holes may be dug for each operation that proves to be productive. In this situation the cost of

[1] *Accounting for Oil and Gas Exploration Costs*, Subject File OI 2220, Item 124, Arthur Andersen & Co., January 1963, page 4.

> the dry holes may be regarded as a part of the cost of the activities that resulted favorably; like the falsework used in the creation of a building they represent preliminary operations necessary to the end result."

It should be emphasized, however, that this is not an endless road as the previous source cautions.

> "This interpretation, of course, must not be pushed to the point of justifying as assets the cost of development operations not warranted in the first place or long continued without success." (Paton, *Asset Accounting*, Ibid.)

Thus, while it may be appropriate to capitalize those unsuccessful ventures which can be related to the finding of successful production, this should not be interpreted as a blank check for loading the rate base with any other costs which have no bearing on productive properties.

Despite the seeming advantages of the project cost model, the record in this proceeding contains a meager amount of evidence directed to estimating a true yield rate of return and relatively much more directed to finding a rate of return under the comparable earnings test which is employed in the cross-section accounting method. With some reluctance in view of the size of the record here, I nevertheless conclude that the evidence on the critical aspect of rate of return on a true yield basis is not adequate to support the use of this method in this case.

My sole exception to the decision relates to the date of division between new and old gas which the majority fix to be January 1, 1961. I dissent to that finding because

it is fundamentally inconsistent with the very basis of the two-price system adopted by the majority. This system was first advanced by witness Kahn and applied by Roseman. Implicit and explicit in their testimony, and as the majority emphasize, the purpose of the two-price system; the purpose of a higher price for new gas, is to provide the incentive to find necessary new reserves. It is a rate designed to encourage the finding of gas in the future, for the future.

The majority's decision repeatedly emphasizes this rationale:

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> "*Looking to the future* we are establishing a pricing system that will encourage the industry to expand and perfect its ability to drill directionally so that revenues from gas consumers can increasingly be devoted to finding additional gas reserves." (p. 29) (emphasis added)
>
> "The incentive is built into the two-price system. *It provides a price for the future* related to current and future costs and payable only to producers who discover gas-well gas and dedicate their discoveries to the interstate market. (p. 29) (emphasis added)
>
> "If a one-price system were to be adopted, average historical costs — not the highest current costs — would necessarily serve as its foundation, and we have no assurance that such a price would elicit the investments at current cost levels which are needed to bring forth adequate new supplies of gas-well gas." (p. 30)
>
> ". . . if such a ceiling were fixed high enough to elicit new gas-well supplies it would result in windfall profits for all other gas and if fixed low enough

to reflect costs for old gas it would not assure adequate supplies for the future." (p. 30)

". . . bring forth needed gas supplies in the future and this fact supports our conclusion to fix a higher ceiling for new gas-well gas which will encourage exploration at deeper horizons directed toward finding gas." (p. 32)

"The separate price we fix herein for new gas-well gas in the Permian Basin should serve to furnish a practical test of whether in fact it will result in bringing forth additional supplies." (p. 32)

It requires no lengthy citations from Webster's dictionary for one to understand that incentive or encouragement relates to the future — not to the past. No matter how hard it tries, the Commission simply cannot incite or encourage a producer to find and dedicate gas to interstate commerce which he is already selling, has been selling for up to four and one-half years, and for which he would need a specific order from the Commission before being free to discontinue.

277,750

Insofar as the majority relies on the issuance of the Policy Statement, the decision strikes a sharp blow at a basic purpose of the Natural Gas Act and the regulatory process. This Statement was issued without notice, without hearing, without any opportunity whatsoever for interested parties to comment. Reliance on such a Statement, the basis of which is devoid of support in the record, is improper. This is especially true since the Statement itself recited:

> "It is anticipated that these differences in price levels will be reduced and eventually eliminated as subsequent experience brings about revisions in the prices in the various areas."

How ironic it must seem to the consumers of this nation that the opposite is true — that our "subsequent experience" is viewed in the light of the Policy Statement.

Looking to the future, it is easy to see that this approach will result in a crazy-quilt maze of old and new gas prices, depending on irrelevant factors such as the length of time required to try the case, and the particular test year used. Thus, "new" gas-well gas can be four and one-half years old in Permian; but in South Louisiana, assuming (but not predicting) a final decision in 1967, "new" gas-well gas will be nearly seven years old! This is some legacy.

Irrespective of how this aspect of the decision is viewed, it makes no sense. I therefore dissent to this aspect of the decision. In my view, the new gas price should relate to gas sold under contracts executed after the date of this decision.

In response to this position which was advanced by the California intervenors, the majority has no rebuttal. It simply states: "We believe, however, that the intervenors' argument proves too much . . . "

Lastly, in order to avoid any future misunderstanding, I wish to note my disagreement with the modifications of the Examiner's method of determining the old gas price as set out in the majority's decision.

In summary, this opinion is a beginning — albeit a good beginning — toward implementing our responsibilities to establish just and reasonable producer rates. I believe that with improvements, including those here suggested which the Commission indicates a willingness to consider, we will make further progress toward achieving a fair and effective system of producer regulation.

/s/ CHARLES R. ROSS
Charles R. Ross, Commissioner

277,751

Area Rate Proceeding Claude E. Aikman, *et al.* North Central Oil Corporation (Operator), *et al.*	*Docket Nos.* G-18466, *et al.* CI60-435, *et al.*

(Issued August 5, 1965)

BLACK, Commissioner, *Concurring:*

I join in today's historic decision but wish to express briefly my separate views with regard to the Commission's determination of rate of return.

In the final analysis the allowance for rate of return is a judgment consideration. With some reluctance I concur in the Commission's exercise of judgment that on the evidence before us 12% is not excessive. I do not feel, however, that the record strongly supports such a consideration.

Because of the great numbers of producers who are affected by our decision in this proceeding and in the area rate cases to follow, the importance of a careful rate of return determination cannot be over emphasized. Translated into terms of the price of Permian gas, the difference between Staff's recommended 9.5% and the Commission's 12% is about 1.5¢ per Mcf for both new gas-well gas and flowing gas. This means about $11 million *annually* to jurisdictional purchasers of Permian gas, or nearly $4.5 million for every percentage point of rate of return.

Serious deficiencies exist in the presentation both of respondents and of the staff on the rate of return question.

The Examiner's basis for adopting a 12% rate of return is equally unsatisfactory. It is based on the earnings experience of nine "highly successful" non-integrated companies whose sales represent only about 4.5% of all jurisdictional sales made in the Permian Basin. Of these nine companies (which in my view is a woefully inadequate number to constitute a representative sampling) only three producers are primarily responsible for bringing the earnings up to the 12% average. And of these three, two were the smallest of any of the exhibit companies. Their total 1960 United States pipeline sales were, respectively, 5.2 million Mcf and 3.2 million Mcf. Their Permian Basin sales were, similarly, but an infinitesimal part of the total. It is apparently conceded that the non-integrated producer is not typical of Permian Basin gas producers;

indeed, the conclusion is unavoidable. Respondents' witness stated on the record that the typical producer is the large integrated company, and that the non-integrated producers constitute a class that is constantly diminishing in number. It is inappropriate that they should have been separated out as the standard for employment of the comparable earnings test. They simply are not comparable.

The Commission avoids any discussion of the adequacy of the non-integrated producer as a basis for comparison and instead rests our case entirely on a discussion of the risks of natural gas production cast in the most general

terms. My colleagues employ as the starting point the rates of return allowed jurisdictional pipeline companies, which fall into the range between 6.0% and 6.5%, and then seek to establish that natural gas production is a riskier business than natural gas transmission. I agree; but the translation of this added risk in terms of percentage points of return on investment has only marginal support in the record and we should acknowledge this to be the fact.

The principal risk which characterizes the operations of the independent producer is, as the main opinion properly notes, the dry hole — or non-commercial well — risk. The Commission points out that we are allowing the recovery of dryhole and associated costs as operating expenses in determining the area price for gas, but goes on to observe that "the uncertainty whether productivity will meet the industry average nevertheless remains as a risk for *each individual producer* . . . ." We are not, of course, making rates on an individual basis. A return of 12% will not obviate the risk of each individual producer in the Permian Basin; nor for that matter will a 50% return. On the Commission's reasoning it could be argued that we would have to allow a rate of return which would cover the least successful operation in the area. A basic rationale of the area-pricing approach as noted more than once in the Commission's opinion is its inherent incentive to exploration. While individual producers may not, in fact, earn a given return on their investment, by the same token no individual producer is *restricted* to a particular return. Efficient, prudent man-

agement — or just plain good luck — can produce a return which in the context of individual company rate making would be termed vastly excessive. But under our approach such companies can keep the fruits of their good fortune.

277,753

We are making rates for the industry as a whole, and the Commission properly observes that "there is a degree of predictability to production operations as evidenced by the fact that the industry as a whole has maintained over extended periods a consistent record of new discoveries and added reserves."

The main opinion effectively disposes of the producers' case for a 16-18% rate of return, and I will not comment further. I do, however, wish to address myself briefly to Staff's approach, which was joined by the California distributor intervenors, with the hope that the records in future area proceedings will provide the Commission with guidance to decide the proper rate of return on a more informed basis.

Staff's evidence, related to over-all earnings experience on total capital, includes the following:

(1) A national group of 35 companies, including both integrated and non-integrated oil and gas producers accounting for some 60% of reported 1960 pipeline sales in the United States. The simple average earnings of this group for the years 1957-1961 amounted to 9.5%, the median 8.8% and the weighted average 9.3%.

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(2) A selection of 31 companies in the Permian Basin (again including both integrated and non-integrated producers) selling 81% of all the gas sold in the Permian Basin in 1960. The same averaging techniques as applied to the national group produced returns of 9.5%, 8.9% and 9.3%, respectively.

Staff also made use of data published by financial institutions, notably the Chase Manhattan Bank and the First National City Bank of New York. The results (both for total manufacturing and for petroleum production and refining) are not markedly different than those produced by Staff's special studies. These statistics, together with information taken from the well-known *Fortune* magazine study of the 500 largest industrial companies, address themselves separately to a return on equity capital. Although today's Commission opinion does not speak in terms of a return on equity, it is nonetheless a traditional and important tool in arriving at a proper rate of return. Using Staff's selected integrated and non-integrated companies, an over-all rate of return of 12% translates into 13.5% return on equity, assuming an equity ratio of 85%.

277,754

Chase Manhattan's group of companies (including Staff's selection) for the entire period 1934-1961 earned 9.44% on average total capital and 10.46% on average equity capital. For the five-year period 1957-1961 earnings on average total capital were 9.56% and 10.44% on average equity capital.

The First National City Bank figures, which included data for a large number of companies representing total manufacturing and a substantial group (124 in 1961) of petroleum production and refining companies, show for the petroleum companies a return of 9.66% on equity for the entire period 1925-1961 and 10.88% for the five-year period 1957-1961.

The *Fortune* study discloses an average of the mean rates of profit on equity for the petroleum industry to have been 8.88% for the years 1957-1961.

I cite these figures, not in an attempt to establish that the Commission's rate of return determination is erroneous, because I recognize that these statistics are in many respects not comparable and are likely subject to a variety of infirmities which make them inappropriate for the Commission to rely heavily on. My purpose is to indicate my belief that an over-all rate of return allowance of 12% is very probably a generous one.

In my view the principal infirmity in Staff's approach is the assumption that the unallocated earnings of the integrated producers necessarily reflects the level of earnings and thus the appropriate rate of return for the separate function of their gas production departments. Staff's position that the non-production operations of the integrated producers are riskier than those of gas production rests largely on argument. While it is true that the far-flung and diverse operations of the large integrated producers may be at least as risky over all as the production of natural gas, the record does not affirmatively support such a conclusion.

The Commission opinion asserts that "integrated returns are relevant to the instant issue" but notes that "Without a departmental segregation of costs and revenues, it is impossible to calculate production department returns."

Whether such a segregation can be made on another record or whether some other reliable means can be devised more accurately to reflect the earnings of gas producers on their jurisdictional investment, I express no opinion. I

only emphasize my strong hope that the Commission's determination of rate of return will not be understood as some kind of immutable standard which we have developed in this pilot decision, or that it will discourage the vigorous and imaginative prosecution of the rate of return case in future area rate proceedings.

Perhaps the most important single reason for a liberal rate of return allowance in the Permian Basin is that the greater part of Permian gas is substantially below pipeline quality. The Commission has provided for downward price adjustments to reflect these quality differentials with the result that much of the gas sold will not command the ceiling prices we have established.[1] The very strong likelihood that the producers will continue

[1] It should be noted, of course, that our allowance of upward adjustments in price to reflect heat value in excess of 1,050 Btu's without a corresponding downward adjustment until Btu content falls below 1,000 undeniably constitutes something of an offset to the producers' risk.

to find large amounts of substandard gas is characterized by the main opinion as a risk factor, and I agree that it is appropriate to reflect this special risk in rate of return, which may well be sufficient to justify a return allowance of 12%.

With the reservations noted above, I expressly concur.

/s/ DAVID S. BLACK
David S. Black, Commissioner

277,756

APPENDIX A, AR61-1, *et al.*

PARTIES AND PROCEEDING CONSOLIDATED[1]

Part I

The order of December 23, 1960, made the following parties Respondents:

Abell, George T.
Ackers, D. E.
Ada Oil Co.
Adams & Ray
Aikman, Claud E.
Aldrich & Fullingim
Amerada Petroleum Corp.
American Trading & Production Corporation.
Anderson-Prichard Oil Corp. (now Union Texas Petroleum, A Division of Allied Chemical Corporation)
Antweil, Morris R.
Bayview Oil Corp.
Beach, Mrs. R. G.
Bell Petroleum Co.
Benedum-Trees Oil Co.
Bird, Ethel W.
Black, Henry Drilling Co., Inc.
Blackwood & Nichols Co.
Blackwood, F. G.
Blanco Oil Co.
Bond Oil Corp.
Bradley, Albert
British-American Oil Producing Co., The
Brown & Key, Inc.

[1] With names of record as of June 30, 1965.

(277,756)

Ard Drilling Co., The
Argo Oil Corporation (now The Atlantic Refining Company)
Ashland Oil & Refining Co.
Atlantic Refining Co., The
August, John J.
Aurora Gasoline Co.
Austral Oil Co., Inc.
Aztec Oil & Gas Co.

BBM Drilling Co.
BTA Oil Producers
Baker & Taylor Drilling Co.
Bakke, W. E.
Bankers Trust Co., Trustee
Barnes, J. C.
Barnes, R. C.
Barnhart Hydrocarbon Corp. (now Northwest Production Corporation)
Barnhart, Paul F.
Baxter, Murphy H.
Brown & Wheeler
Brown, Herman (now Herman Brown Estate)
Brown, James G. & Associates
Burk Royalty Co.
Burns, John J.

Cabot Carbon Co. (now Cabot Corporation)
Cahill, John T.
Callery, F. A., Inc.
Campbell, E. P.
Carper Drilling Co., Inc.
Carter, R. W.
Castleman, Barbara B. (now Barbara B. McComb)
Champlin Oil & Refining Co. (now Champlin Petroleum Co.)
Charm Oil Company
Cherry, A. W.
Christmann, John J.
Cities Service Oil Co.

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Cities Service Production Co. (now Cities Service Oil Co.)
Clark Dale Drilling Co.
Cobb, Dalton H.
Coline Oil Corp.
Colorado Oil & Gas Corp.
Coltexo Corp.
Columbian Carbon Co.
Cone, J. R.
Duncan Drilling Co.
Duncan, J. Walter, Jr.
Duncan, Raymond T.
Duncan, Vincent J.
Duncan, Walter

Elliott & Hall
Elliott, Inc. (now Elliott Oil, Inc.)
Elliott Production Co.

Cone, S. E.
Connally, J. E., d/b/a Connally Oil Co.
Constantin, E., Jr.
Constantine, S. T.
Continental Oil Co.
Coronet Oil Co.
Cosden Petroleum Corp.
Cox, John L.
Crouch, Louis
Cruce, J. L., Jr.
Crumly, L. D., Jr.
Culbertson, E. A. & Irwin, W. W.

Dalport Oil Corp.
Danglade, F. J.
Dansby, Ben, Jr.
Darneille, George J.
Daugherty, J. A.
Davis, Ethel Jo.
Davis, K. W.
Davis, K. W., Jr.
Davison, Leland
Delhi-Taylor Oil Corp. (now Tenneco Oil Company & Continental Oil Company)
Derrick, J. Roy
Dixon Management Corp.
Donnell Drilling Co.
Dorchester Corp. (now Dorchester Gas Producing Company)
Drilling & Exploration Co., Inc.

El Paso Natural Gas Products Co.

Enfield, Robert N.
Eppenauer, A. R.
Evans, David M.

Falcon Oil Corp.
Felmont Oil Corp.
Fields, Bert
Fikes, Leland
Fleet, Howard W.
Fogelson, E. E.
Foree, R. L.
Forest Oil Corp.
Fox, James O., Jr.
Franklin, John M.
French, L. R., Jr.

Gackle, Albert
General American Oil Co. of Texas
General Crude Oil Co.
George Royalty Co.
Getty Oil Co.
Gibbins, J. P.
Goldston Oil Corp.
Goldston, W. L., Estate of
Grace, Joseph Peter
Great Western Drilling Co.
Greene, Hazel
Greenbriar Oil Co. (now Lakeland Petroleum Corporation)
Gruss, Joseph S.
Gulf Oil Corp.

Halbouty, Michael T.
Hall, G. E.
Hall & Stewart Drilling Co.
Hamilton Dome Oil Co., Ltd. (now Westates Petroleum Co.)
Hammonds, George S. Hammonds, Scott (now APCO Corp.)
Hamon, Jake L.
Hanley Co.
Hanlon-Boyle, Inc.
Harper Oil Co.
Hart, Patricia Ruth Carter
Haynes & V. T. Drilling Co.
Herd Oil & Gas Co.
Hernstadt, William L.
Hiawatha Oil & Gas Co.
Hill, John H.
Hitchcock, E. C.
Hodge, T. F.
Honeyman, R. B., Jr.
Honolulu Oil Corp. (now Pan American Petroleum Corp.)
Horne, L. L. (now Estate of L. L. Horne)
Howard, Alvin H. and Vasser, D. E.
Howard, Frank A.
Hudson & Hudson, Inc.
Hudson, William A.
Hudson Co., W. H.
Humble Oil & Refining Co.
Hunt Trustee Estate, Caroline
Hunt, H. L.

Jal Oil Co., Inc. (now Joseph E. Seagram & Sons, Inc., d/b/a Texas Pacific Oil Company)
Jocelyn-Varn Oil Co.
Johnson & French Oil Co.
Johnson, J. Wes, d/b/a Tower Oil & Gas Co. of Texas
Jones, J. E., Drilling Co. (now Sohio Petroleum Co.)
Julkirk Corporation

Kay Kimbell, Oil Properties (now The Estate of Kay Kimbell)
Kelly, John M.
Kerr-McGee Oil Industries, Inc.
Kewanee Oil Co.
Kidd, Barron (now James L. Green, Jr. & Thomas Sloan)
King, Warren, Dye & Yeckel
Kirby Production Co. (now Kirby Petroleum Co.)

Ladenburg, Thalmann & Co.
Lamont, Thomas S.
Latch, Leonard
Late Oil Company
Laughlin, Phil E.
Leonard, J. M.
Leonard Oil Co.

Hunt, Lamar
Hunt, Lyda Bunker, Estate of (now Hunt Industries)
Hunt, N. B.
Hunt Oil Co.
Hunt, W. H.
Hunter, J. D., Trustee
Husky Oil Co.
Indian Royalty Co. (now Cornell Oil Co.)
Inland Natural Gasoline
Inman, Curtis R.
Limpia Royalties, Inc.
Livermore, George P.
Lomax, W. L. (Pete)* & J. P.
*now Gladys Lomax (Mrs. W. L. Pete)
Lone Star Producing Co.
Lowe, Ralph
Lundbeck, G. Hilmer, Jr.
Luse, W. P. & Jack L. Burrell, *et al.*
Lyle, W. M.

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M. W. J. Producing Co.
MacDonald Oil Corp.
Makin Drilling Co.
Maracaibo Oil Exploration Corp.
Markham, Jack
Martin, Williams and Judson
McAlester Fuel Co.
McFarlin, E. B. & Ketchum, E. P.
McGarth and Smith
McKnight, William L., d/b/a La Gorce Oil Co.
Meadows, A. H.
Mendota Oil Co.
Mertzon Corp.
Mesquite Gas Products, Inc.
Miami Petroleum Co., Inc.
Midland National Bank, The, Trustee
Midwest Oil Corp.
Miller, Charles P.
Moberly, George A.
Odessa Natural Gasoline Co.
Ohio Oil Co. (now Marathon Oil Company)
Oil Well Drilling Co.
Olsen Oils, Inc.
Olsen, R., Oil Co. d/b/a Texas Pacific Oil Company (now Joseph E. Seagram & Sons, Inc.)
O'Neill, Joseph I., Jr.
Pan American Petroleum Corp.
Parker Drilling Co. (now R. L. Parker)
Parrish, Grace Marjorie Horan
Pauley Petroleum Inc.
Payne, Clifford E.
Pecos Company
Peerless Oil & Gas Co.
Penrose, Neville G., Inc.

Moncrief, W. A., Jr.
Monsanto Chemical Co. (now Monsanto Company)
Monterey Oil Co. (now Humble Oil & Refining Company)
Moore, J. Hiram
Moore, John I.
Moore, Wayne
Moses, H. L. (now Estate of H. L. Moses)
Moses, Lucy
Mosser, H. J.
Murphy Corp.

Neill, J. P.
Neleh Gas & Oil Corp.
Nemaha Oil Co., Agent
Nolan, Wm. C. & Theodosia M., d/b/a Munoco Company
Norsworthy, Clarence L., Jr.
North Central Oil Corp.
Northern Natural Gas Producing Co.
Norwood Oil Co. and/or Norwood Drilling Co.

Phillips Petroleum Co.
Pioneer Production Corp.
Placid Oil Co.
Poff, H. Bryan
Powell, Celestine V. Trust
Powell, Doless E.
Powell, Len
Powell, Mortimer
Powell, Purnell F.
Prentice Development Corp. (now Irving D. Isko)
Pulaski, Dan J.
Pure Oil Company, The
Putnam, G. D.

Redfern Oil Co.
Reef Corporation
Regester, H. W.
Reigle, E. E., d/b/a Richmond Drilling Co.
Republic Natural Gas Co. (now Socony Mobil Oil Co., Inc.)
Resler & Sheldon
Richardson, Sid W. (now Perry R. Bass)

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Robertson, French M.
Rodman, E. G.
Rodman, E. G. and Noel, W. D.
Rodman, Late & Noel
Rodman-Noel Oil Corp. (now Rodman Petroleum Corp.)

Standard Oil Company of Texas (now Division of California Oil Company)
Starr, J. W.
Stekoll Petroleum Corp. (now Sunac Petroleum Corp.)

Rosenthal, Jerome B.
Rutherford, P. R.
Rutter & Wilbanks Bros. (now DST Exploration Corp.)
Ryan, Katherine

Samedan Oil Corp.
Sands, Caroline H. & Lloyd B.
Santa Rosa Gas Co.
Sapphire American Petroleums, Inc. (now Richard C. Davoust)
Saturn Drilling Co.
Scarborough, Warren
Schermerhorn Oil Corp.
Scott, Paul P., Trust
Secure Trusts
Sharp, J. R., Inc.
Sharples Oil Corp., The
Shea, Edward L.
Shell Oil Co.
Signal Oil & Gas Co.
Simmons, Jay
Sinclair Oil & Gas Co.
Skelly Oil Co.
Slade, Inc.
Slick Oil Corp. (now Midhurst Oil Corporation)
Snowden, James H.
Socony Mobil Oil Co., Inc.
Sohio Petroleum Co.
Southern California Petroleum Corp. (now Reserve Oil & Gas Company)
Stout, Billy J.
Street, Gordon, Inc.
Street, Gordon P.
Sun Oil Co.
Sunray Mid-Continent Oil Co. (now Sunray DX Oil Co.)
Sunset International Petroleum Corp.
Sunshine Royalty Co.
Superior Oil Co., The

TXL Oil Corp., The
Tela Corporation
Terrill, J. W.
Texaco Inc.
Texaco Seaboard, Inc. (now Texaco Inc.)
Texas Crude Oil Co.
Texas Gas Products Corp. (now Union Texas Petroleum, A Division of Allied Chemical Corporation)
Texas Gulf Producing Co. (now Sinclair Oil & Gas Co.)
Texas-Hanover Oil Co.
Texas Hydrocarbon Co. (now Union Texas Petroleum, A Division of Allied Chemical Corporation)
Texas National Petroleum Co. (now Union Oil Co. of California)

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Southern Petroleum Exploration Inc.
Southern Union Gas Co. (now Southern Union Production Company)
Southland Royalty Co.
Spence, Aurelia, Mrs.
Texas Pacific Coal & Oil Co. (now Joseph E. Seagram & Sons, Inc. d/b/a Texas Pacific Oil Company)
Thornbury, D. H.
Three States Natural Gas Co.

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Tidewater Oil Co.
Todd, W. L., Jr.
Tres Oil Co.
Tri-Service Drilling Co.
Trice Production Co.
Tucker, R. C.
Turner, Fred, Jr.
Two States Oil Co.

Union Oil Company of California
United States Smelting Refining and Mining Co.

VEM Oil, Inc.
Vaughn, G. H., Jr. and Jack C. Vest, Earl & Sam; Dorbandt, Arnett; Ross, Bert

Warren Petroleum Corp.
Watts, Ed. E.
Weier Drilling Co. (now A. D. Weier, Jr., et al.)
Welborn, J. M.
West Texas Gathering Co.
Westbrook-Thompson Holding Corp.
Western Development Company of Delaware
Western Natural Gas Co. (now Sinclair Oil & Gas Company)
Western Oil Fields, Inc.
Western Petroleum Co. (now CRA, Inc.)
Westlund, Carl J., Inc.
Willetts, Elmore A., Jr. and Craig, Earle M., Jr.
Williams, D. A.
Williamson, J. C.
Wolfson, Reuben I. & Sam
Wrightsman, Charles B. (now Wrightsman Petroleum Company)

Young, Marshall R.

Zachary, J. M.

Part II

The following Respondents were eliminated as parties to the proceeding by subsequent orders of the Commission:

American Trading & Production Corp.
Barnes, R. C.
Bayview Oil Corporation
Bond Oil Corporation
Coline Oil Corporation
Columbian Carbon Company
Coronet Oil Company
Dansby, Ben, Jr.
Falcon Oil Corporation
Felmont Oil Corporation
Greene, Hazel
Halbouty, Michael T.
Hanlon-Boyle, Inc.
Howard, Alvin H. & D. E. Vasser
Indian Royalty Company
Kerr-McGee Oil Industries, Inc.
Maracaibo Oil Exploration Corp.
Mosser, H. J.
Poff, H. Bryan
Ryan, Katherine
Snowden, James H.
Tela Corporation
Terrill, J. W.
Young, Marshall R.

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Part III

The following proceedings involving proposed increases in rates were consolidated. Proceedings marked with "*" are consolidated only insofar as they pertain to the Permian Basin, New Mexico and Texas Railroad Commission Districts Nos. 7-C and 8 areas. Regarding proceedings marked with "**", there remains open the question of the contractual support of the respondents to make the increased rate filings. This question will be determined in Amerada Petroleum Corporation, *et al.*,

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CARD 24

(277,762)

Docket Nos. G-16117, et al., and *Phillips Petroleum Company,* Docket Nos. G-11217, *et al.*

Producer	Docket No.
Aikman, Claud E.	G-18466, R160-73
Amerada Petroleum Corporation	G-19488**, G-19577**, G-20390, RI60-353
Amerada Petroleum Corporation, *et al.*	G-19489**
Amerada Petroleum Corporation (Operator), *et al.*	G-19490**, RI60-354
Apco Oil Corporation (formerly George S. Hammonds)	G-16520
Apco Oil Corporation, *et al.* (formerly Scott Hammonds, *et al.*)	G-16521
Ard Drilling Company, The	RI60-90
Ashland Oil and Refining Company	RI60-329
Atlantic Refining Company, The (formerly Argo Oil Corporation)	RI60-177
Austral Oil Company, Inc., Agent for Oil Participants, Inc.	G-19540**

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Producer	Docket No.
Aztec Oil and Gas Company	RI61-201
BTA Oil Producers (Operator), *et al.*, and Shell Oil Company (formerly BTA Oil Producers (Operator), *et al.*)	G-20525

Bakke, W. E. (Operator), *et al.*, Sohio Petroleum Company (Operator), *et al.*, and Abel & Bancroft (Operator), *et al.* (formerly W. E. Bakke, (Operator), *et al.*)	G-16477**
Barnhart, Paul F., *et al.*	G-13985, G-14017
Barnhart, Paul F.	G-14018
Baxter, Murphy H. (Operator), *et al.*	G-14181
Benedum-Trees Oil Company	G-12881**, G-20522
Bird, Ethel W., *et al.*	RI60-190
Black, Henry, Drilling Company, Inc. (Operator), *et al.*	RI60-105
Blackwood, F. G., *et al.*	G-18515
Blanco Oil Company, *et al.*	G-20402
British-American Oil Producing Company, The	G-14028, G-19254**
Brown, H. L., Estate, *et al.* (formerly Brown and Wheeler, *et al.*)	RI60-4
Brown, Herman, Estate (formerly Herman Brown)	RI60-82
Brown, James G. & Associations (Operator), *et al.*, and Tamarack Petroleum Company, Inc., Agent, *et al.*	RI60-346

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Producer	Docket No.
Cabot Corporation (SW) (formerly Cabot Carbon Company)	G-18842**

(277,765)

Cabot Corporation (SW) and Sinclair Oil & Gas Company (formerly Cabot Carbon Company)	G-18844**, RI60-27
Callery, F. A., Inc., *et al.*	G-19645**, RI60-395
Charm Oil Company	G-19491**, RI60-206
Cities Service Oil Company	G-20393, G-20395
Cities Service Oil Company (Operator), *et al.*	G-20394
Cities Service Oil Company (formerly Cities Service Production Co. (Operator), *et al.*)	G-20396
Connally, J. E. d/b/a Connally Oil Company (Operator), *et al.*	RI60-104
Constantine, S. T. (Operator), *et al.* and Roy E. Kimsey, Jr. (Operator), *et al.* (formerly S. T. Constantine (Operator), *et al.*)	RI60-43
Continental Oil Company	RI61-87
Continental Oil Company (Operator), *et al.*	RI61-86
Cox, John L.	RI60-115, RI60-321
Cox, John L. (Operator), *et al.*	RI60-272

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Producer	Docket No.
Crumly, L. D., Jr.	RI61-42
Crumly, L. D., Jr. and Tom Schneider (formerly L. D. Crumly, Jr.)	G-20530
Culbertson, E. A. and W. W. Irwin	RI60-153

Dalport Oil Corporation, *et al.*	G-20397
Dalport Oil Corporation (Operator), *et al.*	G-20398
Davidson, Leland, *et al.*, Humble Oil & Refining Company and Continental Oil Company (formerly Leland Davidson, *et al.*)	RI60-467
Davidson, Leland, *et al.* and Humble Oil & Refining Company (formerly Leland Davidson, *et al.*)	RI61-54
Davoust, Richard C. (formerly Stanton Oil Company, Ltd.)	RI61-106
Donnell Drilling Company	G-14736
Dorchester Gas Producing Company (Operator) (formerly Dorchester Corporation (Operator))	RI60-11
Elliott, Oil Inc. (formerly Elliott, Inc.)	RI60-228
Elliott Production Company	RI60-212
Enfield, Robert N.	RI60-87

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Producer	Docket No.
Eppenauer, A. R.	G-20524
Fleet, Howard W., *et al.*	RI60-157
Foree, R. L.	G-20539
Forest Oil Corporation	RI60-107
French, L. R., Jr.	G-19726
French, L. R. Jr. (Operator), *et al.*	G-17347**, G-19725, RI60-9
Gackle, Albert (Operator), *et al.*	G-13940, G-14045 RI60-151

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Gackle, Albert, Agent, (Operator), *et al.*	RI60-117
General American Oil Company of Texas	RI60-248
Getty Oil Company	G-16533**, RI60-72**, RI61-19
Goldston, W. J., Independent Executor of Estate of W. L. Goldston, Deceased, *et al.*	RI60-343
Greene, James L., Jr., *et al.* (formerly Barron Kidd)	RI60-109[1]
Gruss, Joseph S.	RI60-74, RI 60-461
Gulf Oil Corporation (Operator), *et al.*	G-20399
Gulf Oil Corporation	G-20400
Hall, G. E. (Operator), *et al.*	G-15175

277,767

Producer	Docket No.
Hamon, Jake L. (Operator), *et al.*	G-18327**, RI60-112
Hamon, Jake L.	RI60-106
Hanley Company (Operator), *et al.*, DST Exploration Corporation (Operator) *et al.*, and Humble Oil & Refining Company (formerly Hanley Company)	RI60-76
Hanley Company	RI60-75
Hanley Company, *et al.*	RI60-77
Harper Oil Company (Operator), *et al.*	RI60-200

[1] Peter B. Smith has filed a motion to be made respondent in this proceeding.

Herd Oil and Gas Company	G-18769**
Horne, L. L., Estate of (formerly L. L. Horne)	G-18268
Hudson, W. H. Company	RI60-156
Humble Oil and Refining Company (Operator), *et al.*	G-16415**[2], G-18172**, RI60-443[2], RI60-473
Humble Oil & Refining Company (formerly Monterey Oil Company)	RI60-42
Humble Oil & Refining Company	G-16416**, G-19487**, RI60-430 RI60-444, RI60-447
Humble Oil & Refining Company (Operator), *et al.* (formerly Monterey Oil Company (Operator), *et al.*)	G-17799**, G-18568**, RI60-28, RI60-80
Hunt, H. L.	G-16421**, G-18554, G-20527, RI60-84, RI60-324
Hunt, H. L., *et al.*	RI60-110

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Producer	Docket No.
Hunt-Margaret, Lyda, Trust, *et al.* (formerly Estate of Lyda Bunker Hunt)	G-18556
Hunt Industries (formerly Estate of Lyda Bunker Hunt)	G-16423**, G-20535

[2] Amerada Petroleum Corporation has filed a motion to be made a co-respondent in this proceeding.

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Hunt, Lamar	G-16418**, G-17424**, G-18847, G-20528
Hunt, N. B.	G-16420**, G-16478**, G-18557, G-20533
Hunt, W. H.	G-16419**, G-17425**, G-18848, G-20534
Husky Oil Company (formerly Husky, Inc.)	G-19722
Inland Natural Gasoline	G-19992**, RI60-91
Jocelyn-Varn Oil Company (Operator), *et al.*	RI60-36
Johnson, J. Wes d/b/a Tower Oil & Gas Company of Texas, Jeanne Kerbs, W. A. Morel and Walter E. Heller & Company (formerly J. Wes Johnson d/b/a Tower Oil & Gas Company of Texas)	RI60-276
Jones, J. E., Drilling Company (Operator, *et al.*, and Sohio Petroleum Company (Operator), *et al.* (formerly J. E. Jones Drilling Company (Operator), *et al.*)	G-14762
Kewanee Oil Company	G-15235, RI61-155
Kimbell, Kay The Estate of, *et al.*; and Chase Petroleum Company (Operator), Agent for John M. Clark, *et al.* (formerly Kay Kimbell Oil Properties, *et al.*)	G-20538

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Producer	Docket No.
Kirby Petroleum Company (Operator), *et al.* (formerly Toklan Production Company, *et al.*)	G-13838, RI60-311
Lakeland Petroleum Corporation (formerly Greenbrier Oil Company and Theo. Hamm Brewing Co.)	RI60-22, RI60-23
Latch, Leonard, *et al.*	RI60-328
Late Oil Company (Operator), *et al.*	G-14495
Leonard Oil Company	RI60-44, RI60-113
Leonard, J. M.	RI61-226
Limpia Royalties, Inc.	G-14761
Luse, W. P., *et al.*, and Jack L. Burrell (Operator), *et al.* (formerly W. P. Luse, *et al.*)	RI60-37
Lyle, W. M., *et al.*	G-20419
MWJ Producing Company (Operator), Agent	RI60-88, RI60-188
MacDonald Oil Corporation (Operator), *et al.*	RI60-258, RI60-419
Marathon Oil Company (formerly The Ohio Oil Company)	RI60-260
Marathon Oil Company (Operator), *et al.* (formerly The Ohio Oil Company (Operator), *et al.*)	RI60-259
Markham, Jack, *et al.*	RI60-222
Martin, Williams & Judson (Operator), *et al.*	RI60-89

Producer	Docket No.
McAlester Fuel Company	G-19324
McFarlin, E. B., and Ketchum, E. P.	G-13161**, RI60-24
McGrath & Smith (Operator), *et al.*	RI60-316
McGrath & Smith, Inc., Agent (Operator), *et al.* (formerly Carl J. Westlund, Inc. (Operator), *et al.*)	RI60-196
McKnight, William L. d/b/a La Gorce Oil Company, *et al.*	RI60-315
Meadows, A. H.	RI60-33
Mendota Oil Company	RI60-314, RI60-351
Midhurst Oil Corporation	RI60-103
Monsanto Company (formerly Monsanto Chemical Company)	RI60-122
Moore, J. Hiram, *et al.*	RI60-3
Moore, Wayne, *et al.*	G-20416
Northwest Production Corporation (formerly Barnhart Hydrocarbon Corporation)	G-16417**, G-20418
Nueces Company, The (Operator) (formerly Santa Rosa Gas Company (Operator))	G-17165**, G-20412
Odessa Natural Gasoline Company	RI60-5
Oil Well Drilling Company, *et al.*	RI60-152

Producer	Docket No.
O'Neill, Joseph I., Jr., *et al.*	RI60-320
Pan American Petroleum Corporation	G-16480**, G-16532**, G-19998**, G-20452**, RI61-43, RI61-58
Pan American Petroleum Corporation (Operator), *et al.*	G-20008**, RI61-45
Pan American Petroleum Corporation (Operator)	G-16481**, G-20006**, RI61-53
Pan American Petroleum Corporation, *et al.*	G-20007**
Pan American Petroleum Corporation and Hanley Company (Operator), *et al.* (formerly Pan American Petroleum Corporation)	RI61-44
Pan American Petroleum Corporation (formerly Honolulu Oil Corporation)	G-16425**, RI60-32
Pan American Petroleum Corporation (Operator), *et al.* (formerly Honolulu Oil Corporation (Operator), *et al.*	G-17059
Pauley Petroleum Inc., *et al.*	G-20529
Pecos Company	RI60-34
Pecos Company (Operator)	RI60-35
Peerless Oil & Gas Company and The Fluor Corporation, Ltd. (formerly Peerless Oil & Gas Company)	G-20401

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Producer	Docket No.
Phillips Petroleum Company	G-11849, G-13734**, G-15315**, G-18207**, G-18215**, G-20405, G-20523, RI60-2, RI60-15
Phillips Petroleum Company (Operator), *et al.*	G-14006, G-15314**, G-18206**, G-18418**, G-20403*
Phillips Petroleum Company (Operator)	G-14115**, G-17071, G-18417**, G-20404, G-20417, RI61-30
Pure Oil Company, The	G-16800**, G-17930, G-17937**, G-20005, G-20280, RI60-91, RI60-418
Redfern Oil Company	G-18770**
Reef Corporation (Operator), *et al.*	RI61-66
Reigle, E. E., d/b/a Richmond Drilling Company	RI60-38
Reserve Oil & Gas Company, *et al.*, Husky Oil Company, Haynes & V. T. Drilling Company and Reserve Oil & Gas Company (formerly Southern California Petroleum Corporation)	RI60-13
Reserve Oil & Gas Company (Operator), *et al.* (formerly Southern California Petroleum Corporation)	RI60-12
Resler & Sheldon (Operator), *et al.*	G-19492

Robertson, French M. (Operator), *et al.*	RI61-244
Robertson, French M. & J. P. Bryan (formerly G. Stratton, Jr. (Operator), *et al.*	G-16535
Rodman, E. G. (Operator), *et al.*	G-19994, RI60-7
Rodman, E. G. & W. D. Noel	RI60-6
Rodman, Late & Noel[3]	G-19952

277,773

Producer	Docket No.
Rodman Petroleum Corporation (Operator), *et al.* (formerly Rodman-Noel Oil Corporation)	G-19996
Rosenthal, Jerome B., *et al.*	RI60-414
Rutter & Wilbanks Brothers (Operator), *et al.* and DST Exploration Corporation (formerly Rutter & Wilbanks Brothers (Operator), *et al.*)	RI60-155
Schermerhorn Oil Corporation, *et al.*	RI60-40, RI60-81
Schemerhorn Oil Corporation	RI60-41
Scott, Paul P. Trust, *et al.*	RI60-108, RI61-98

[3] Motion filed of change of name to "Rodman and Late."

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Seagram, Joseph E. & Sons, Inc., d/b/a Texas Pacific Oil Company (Operator), *et al.* (formerly Jal Oil Company, Inc. (Operator), *et al.*)	RI60-256, RI60-350, RI60-380
Seagram, Joseph E. & Sons, Inc., d/b/a Texas Pacific Oil Company (formerly Jal Oil Company, Inc.)	RI60-362, RI60-442
Seagram, Joseph E. & Sons, Inc., (formerly Olsen Oils, Inc.)	G-20003
Seagram, Joseph E. & Sons, Inc., d/b/a Texas Pacific Oil Company (Operator) *et al.* (formerly Olsen Oils, Inc. (Operator), *et al.*)	G-20002, RI60-118
Seagram, Joseph E. & Sons, Inc., d/b/a Texas Pacific Oil Company (formerly Texas Pacific Coal & Oil Company)	RI60-453, RI60-469
Seagram, Joseph E. & Sons, Inc., d/b/a Texas Pacific Oil Company (Operator) *et al.* (formerly Texas Pacific Coal & Oil Company (Operator), *et al.*)	RI60-470
Secure Trusts	G-16424**, G-18558, G-20536
Sharples & Company Properties (Operator), *et al.* (formerly Sharples Oil Corporation)	G-14253, G-14624

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Producer	Docket No.
Signal Oil & Gas Company (Operator), *et al.*	RI60-219
Signal Oil & Gas Company (Operator), *et al.* (formerly John I. Moore, *et al.*)	RI60-120
Signal Oil & Gas Company, *et al.*	RI60-305
Simmons, Jay, *et al.*	RI60-154, RI60-197
Sinclair Oil & Gas Company	G-16534**, G-16956, G-18326**, G-19723**
Sinclair Oil & Gas Company (Operator), *et al.*	G-20082*
Sinclair Oil & Gas Company, *et al.*	G-19724
Sinclair Oil & Gas Company and NE-O-TEX Corporation (formerly Sinclair Oil & Gas Company)	RI60-31
Sinclair Oil & Gas Company (Operator), *et al.* (formerly Texas Gulf Producing Company (Operator), *et al.*)	G-14066, G-16537**, RI60-25
Sinclair Oil & Gas Company and Amerada Petroleum Corporation (formerly Sinclair Oil & Gas Company)	G-20580, RI61-56*
Sinclair Oil & Gas Company (Operator), *et al.* (formerly Western Natural Gas Company)	G-19252, RI60-45

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Sinclair Oil & Gas Company (formerly Texas Gulf Producing Company)	RI60-26
Skelly Oil Company	RI61-88
Slade, Inc.	RI60-147
Slade, Inc. (Operator), *et al.*	RI60-179

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Producer	Docket No.
Socony Mobil Oil Company, Inc.	G-12981**, G-12982**, G-13030**, G-15448**, G-15449**, G-15995**, G-20407, RI60-46
Socony Mobil Oil Company, Inc. (Operator)	G-20408
Socony Mobil Oil Company, Inc. (Operator), *et al.*	RI61-94
Socony Mobil Oil Company, Inc. (formerly Republic Natural Gas Company)	RI60-10
Socony Mobil Oil Company, Inc., (formerly Republic Natural Gas Company, *et al.*)	G-13311**
Socony Mobil Oil Company, Inc. (Operator), *et al.* and The Atlantic Refining Company (formerly Socony Mobil Oil Company, Inc. (Operator) *et al.*)	G-20406
Sohio Petroleum Company (Operator), *et al.*	RI60-8
Southern Union Production Company (formerly Southern Union Gas Company)	G-19483**, RI60-242

Southland Royalty Company	G-19727**, RI60-119, RI60-148, RI61-50
Southland Royalty Company (Operator), *et al.*	RI60-306
Standard Oil Company of Texas, a Division of California Oil Company	G-14059**, G-19583**, RI60-164**, RI60-337**, RI61-161
Standard Oil Company of Texas, a Division of California Oil Company	G-13187**, G-19664**, RI60-338

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Producer	Docket No.
Street, Gordon, Inc.	RI60-86
Street, Gordon, Inc. (formerly Gordon P. Street)	RI60-85
Sunac Petroleum Corporation (Operator), *et al.*, and DST Exploration Corporation (Operator), *et al.* (formerly Stekoll Petroleum Corporation (Operator), *et al.*)	RI60-114
Sun Oil Company	RI60-123
Sun Oil Company (Operator), *et al.*	RI60-124
Sunray DX Oil Company (formerly Sunray Mid-Continent Oil Company)	G-13160**, G-16884**, G-19090**, G-20537, RI60-14, RI60-29, RI60-101
Superior Oil Company, The	G-12949**, G-12950**[4], G-15358**[4], G-18771, G-20075

[4] Amerada Petroleum Corporation has filed a motion to be made a co-respondent in this proceeding.

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Tenneco Oil Company and Continental Oil Company (formerly Delhi-Taylor Oil Corporation)	G-19728**, RI60-278, RI60-322
Texaco Inc. (formerly The TXL Oil Corporation)	RI60-224
Texaco Inc.	G-16414**, G-17159**, RI60-132**, RI60-137**, RI60-142**, RI60-466, RI61-33, RI61-74
Texaco Inc. (formerly Texaco Seaboard Inc.)	G-14194

277,777

Producer	Docket No.
Tidewater Oil Company	G-14061**, G-14185**, G-16259**, RI60-71**, RI61-17
Tidewater Oil Company (Operator), *et al.*	G-16260**, RI60-70**, RI61-18
Todd, W. L., Jr., *et al.*	G-20415
Tri-Service Drilling Company	RI60-454
Trice Production Company (Operator), *et al.*	RI60-234
Turner, Fred, Jr.	RI60-83
Two States Oil Company	RI60-39
Union Oil Company of California (formerly Texas National Petroleum Company)	RI60-325, RI61-27
Union Oil Company of California	G-13997, RI60-174, RI60-438

Union Oil Company of California (formerly Texas National Petroleum Company (Operator), *et al.*)	RI61-26
Union Texas Petroleum, a Division of Allied Chemical Corporation (Operator), *et al.* (formerly Texas Gas Products Corporation (Operator), *et al.*)	G-16888**, G-18952**, G-20420
Union Texas Petroleum, a Division of Allied Chemical Corporation (formerly Texas Hydrocarbon Company)	G-16889**, G-18951**, G-20421
Union Texas Petroleum, a Division of Allied Chemical Corporation (formerly Anderson-Prichard Oil Corporation)	G-19644, G-19651, RI60-121, RI60-149
Union Texas Petroleum, a Division of Allied Chemical Corporation (Operator), *et al.* (formerly Anderson-Prichard Oil Corporation (Operator), *et al.*)	G-19638, RI60-150

277,778

Producer	Docket No.
Vaughn, G. H., Jr. & Jack C., *et al.*	G-20413
VEM Oil Inc. and B. W. P., Inc. (formerly VEM Oil, Inc.)	RI60-116
Warren Petroleum Corporation	G-12842**, G-15311**, G-16114**, G-18560**, G-20410

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Warren Petroleum Corporation (Operator)	G-15304**, G-15310**, G-18467**, G-18471**, G-18517**, G-20409
Weier, A. D., Jr. *et al.* (formerly Weier Drilling Company) (Operator), *et al.*	RI60-261
Westates Petroleum Company (formerly Hamilton Dome Oil Company, Ltd.)	G-20414
Western Petroleum Company and CRA, Inc., *et al.* (formerly Western Petroleum Company)	G-20411
Wilshire Oil Company of Texas (formerly Nemaha Oil Company)	RI60-78
Wilshire Oil Company of Texas, Agent for the Estate of Herbert W. Grindal, *et al.* (formerly Nemaha Oil Company, Agent, *et al.*)	RI60-79
Wrightsman Investment Company (formerly Charles B. Wrightsman)	G-20540

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Part IV

The following certificate proceedings were also consolidated:

Producer	Docket No.
Brown, Robert T., Operator, *et al.*	CI61-733
North Central Oil Corporation (Operator), *et al.*	CI60-435

Nortex Oil and Gas Corporation & Socony Mobil Oil Company — Temporary issued 7/10/64 — CI61-34

TXL Oil Corporation, The (Texaco Inc. substituted as party 6/31/62) — CI61-879

277,780

Part V

Parties whose petitions to intervene were granted by orders dated May 31, 1961 and July 26, 1961:

Public Service Commission of Wisconsin

Minneapolis Gas Company

Public Utilities Commission of State of California and People of the State of California

David Fasken

Delta Drilling Company

W. H. Black (Operator)

DST Exploration Company

G. E. Marsh, II

J. H. Vandenbark (Operator)

The City of Los Angeles

Abel & Bancroft

James L. Green, Jr. and Thomas M. Sloan

J. H. Bartley, Norman Bock, A. W. Lasher, Jr. & William Moss

Dekalb Agricultural Association, Inc.

The State of Wisconsin

West Central Texas Oil and Gas Association

Iowa Public Service Company

Texas Independent Producers and Royalty Owners Association

City and County of San Francisco, California

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San Diego Gas & Electric Company
Pacific Gas and Electric Company
State of New Mexico
Jeanne E. Krebs
Big Chief Drilling Company
American Liberty Oil Company
El Paso Natural Gas Company
Transwestern Pipeline Company
Minnesota Valley Natural Gas Company
Iowa Electric Light and Power Company
King-Stevenson Oil Company, Inc.
Pacific Lighting Gas Supply Company, Southern California Gas Company and Southern Counties Gas Company of California
Service Drilling Company
The State of Texas
Northern States Power Company
E. R. Bahan
Central Natural Gas Company
Metropolitan Utilities District of Omaha
Independent Petroleum Association of America
Fuels Research Council, Inc.
The City of San Diego

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Woolaroc Oil Company
Iowa Power and Light Company
Central Electric and Gas Company (now Western Power & Gas Company)
Northern Natural Gas Company
J. M. Armstrong & W. A. Yeager
C. A. McClintic
Delfern Oil Company

APPENDIX B, Docket Nos. AR61-1, et al.

The following discussion from the presiding examiner's initial decision, Appendix B, pages 84-85, is adopted by the Commission:

E. DRY HOLE COSTS

Roseman and Park divide dry hole costs on the basis of the relationship between successful oil and gas well footage averaged over a period of years. While this method might not be suitable for dealing with the dry hole costs of an individual company due to the variations in annual success ratios and productivity of successful drilling, as Respondent witness Porter showed, these variations tend to be minimized in the magnitude of the industry's total effort over a period of years. Therefore these witnesses' basic approach is sound on the industry level.

For the period 1955-60, Park determines the average annual dry hole footage and successful footage, separately for exploratory and developmental footage. This shows that 6.4 feet of dry holes were drilled for each successful exploratory foot, and 0.3 feet per successful developmental foot. These numbers are multiplied by the average annual gas footage, broken down between exploration and development, thus arriving at the total dry hole footage to be borne by gas well gas. The total is then multiplied by the JAS 1960 average cost per foot for dry holes. The result is divided by the average annual reserve additions of gas well gas to produce 1.56 cents per Mcf for dry holes. Park thus allocates dry hole costs

in proportion to the relationship between successful gas footage and total successful footage.

Roseman also divides his dry hole footage between gas and oil in proportion to successful gas and oil footage, separately for "wildcat"[3] and other footage. He derives a combined ratio of 0.898 feet of dry hole per successful gas well footage as the weighted average for the period 1951-61. (The corresponding ratio for Park for the period 1955-60 is 0.891.) Then he takes the cost per dry hole foot drilled from the Census for 1958 and after adjustment computes the cost per Mcf of dry holes drilled.

Roseman makes three adjustments to the dry hole foot cost figure of $8.91, the Census figure for 1958.

The Appendix figures show a decline of 3.5 percent in dry hole drilling costs from the peak year 1958 to 1960. For the reasons previously given, it is appropriate to adjust the 1958 Census level by the trend actually experienced by the constant sample of companies in the Appendix. This adjustment reduces the cost per dry hole foot to $8.60 per foot.

Roseman makes a second adjustment to take account of the fact that gas wells are typically deeper and therefore more expensive than oil wells. Using the *Oil and Gas Journal* figures which show drilling footage by depth and by well type, and Appendix data which shows the

[3] *World Oil*, on which Park and Roseman rely for allocating dry hole costs, provides a breakdown between "wildcat" and total drilling. It appears that the term exploratory as used here by Park corresponds to the term "wildcat" used in *World Oil*.

Appendix cost per foot for 1960 in the various depth ranges, he finds that the average cost per foot of dry holes allocated to gas was 12 percent greater than it would have been, if depth had been disregarded.

Again, analysis of the figures allocated to gas by Roseman on the basis of successful wells at various depth ranges, indicates that the footage allotted to gas is 4 percent less than if, disregarding depth ranges, the allocation were made simply on the ratio of total successful gas well to oil well footage. This

is a statistical indication that deeper wells tend to have a higher success ratio. The combination of the second and third adjustments, an increase in cost of 12 percent for greater depth and a reduction of 4 percent for greater success ratio, results in an upward adjustment of 8.28 percent.

The adjusted cost per foot figure is $9.31 per foot which produces a cost of 1.42 cents per Mcf.

Roseman's trended Census cost per foot is preferred to Park's JAS cost. The JAS sample average cost reflects the overrepresentation of large producers, their deeper than average drilling, and consequent higher than average cost per foot. Roseman's adjustments which reflect the effects of depth and success ratios for gas wells are sound refinements. For these reasons Roseman's estimate of 1.42 cents is accepted.

The following discussion from the presiding examiner's

initial decision, Appendix B, pages 80-83, is adopted by the Commission:

B. LEASE ACQUISITION COSTS

Park, Roseman and Sherwin estimate lease acquisition costs for gas well gas on the basis of the relationship between lease acquisition costs and successful well drilling costs.

Data on leasehold acquisition costs in relation to successful drilling costs are available from the Staff Appendices B and C, the *Joint Association Survey* and the Chase Manhattan Bank's *Annual Analysis of the Petroleum Industry 1961* (Chase). Ratios between leasehold acquisition costs and successful drilling costs cannot be computed from the Chase data alone because the Chase drilling costs include lease equipment costs which cannot be broken out. However, the Chase figures for lease acquisition costs are separate. Roseman used this data and related it to the trended Census drilling costs (the Chase-Census results). The ratios from the above sources are shown for recent years below.

There is difficulty in using the data on this subject.

1. Lease acquisitions vary considerably from year to year and are significantly influenced by Federal offshore lease sales at which large blocks are sold at irregular intervals, chiefly to large producers. As shown below, the expenditures for leaseholds by the small producers have been stable in relation to drilling costs, while the expenditures of the large producers have varied significantly. Given the variability in the ratios, it is desirable to consider the results

Ratio of lease acquisition costs to successful well costs (percent)

	JAS	Roseman	Staff summaries	
			Respondents Over 10 million	Respondents Under 10 million
	(1)	(2)	(3)	(4)
1955	36	36	N.A.	N.A.
1956	29	28	41	28
1957	N.A.	20	27	23
1958	N.A.	23	39	24
1959	30	28	43	28
1960	38	36	67	28
1961	26	24	N.A.	N.A.
Weighted average	33	[1]26.4	42	26

[1] Years 1957, 1958, 1959, 1960.

Source:

(1) Joint Association Survey, 1961; and 137/14381.

(2) Exhibit 224, Sch. 5; and 173/20614.

(3) Exhibit 149, p. 32.

(4) Exhibit 149, p. 45 and Exhibit 153, p. 12. Data in Exhibit 153 adjusted to separate out related lease equipment from reported total of "well equipment and related lease equipment."

N.A. = Not available.

for a number of consecutive years. The JAS does not report any results for 1957 and 1958. The Chase-Census figures are available over a span of years and the Appendix data covers 1956-60.

* * *

To relate lease acquisitions to drilling cost, Roseman estimated drilling costs for oil and gas separately from the

Census for 1958 and trended these results on the basis of the Appendix A experienced costs from 1957-60. The per foot results for oil and gas were applied to the total footage drilled of oil and gas wells as reported in *World Oil*, to obtain the total drilling costs for each year. As previously discussed, trending the drilling data on the basis of the trends shown in the Appendix A is a sound method for determining trends in drilling costs. Trending the 1958 drilling costs downward increases the ratio of lease acquisition costs to drilling costs. Roseman then relates the industry wide lease acquisition data of the Chase analysis to the trended industry drilling costs. He considers the annual ratios from 1955-61 * *

and correctly found no trend. He then determines the weighted average ratio for the years 1957-60 to be 26.4 percent, which provides a representative sample of years in which lease acquisition costs were at high and low levels. Applying this percentage to his drilling cost of 2.88 cents per Mcf for successful gas wells, determined from the first step, yields 0.76 cents per Mcf.

Sherwin's estimate for the relationship between lease acquisition costs and successful well costs is in the range of 33 to 37 percent. He begins with the Appendix data which for the years 1956-60 average 42 percent for the large producers and 26 percent for the small producers. He also considers the lower estimates of JAS and Chase. JAS doesn't cover the years 1957 and 1958, which the other estimates show were the two lowest years in any of the series. It is evident from the preceding table that for all the years JAS is available 1955, 1956, 1959, 1960,

1961, its ratios are never more than two percentage points higher than the Chase-Census ratios.

Sherwin's major reliance is the Appendix data for the large producers. The ratios for these large producers are much higher than either the JAS or the Chase-Census ratios. The ratio of 67 percent for 1960 is 29 percentage points above the JAS figure for that year and 30 points above the Chase-Census ratio. This last variance is probably due in part to extensive purchases by large producers of offshore leases at the federal sales occurring that year. Such lease sales are in the main confined to large producers and their affiliates, and are generally in large amounts. These transactions are reflected to a greater degree in the Appendix results for the large producers than in the JAS or the Chase-Census results, because the national Appendix data underrepresent the small companies to a greater extent than the other two. Sherwin's upper limit of 37 percent is based in the main on an apparent trend in the results for the large Appendix producers for 1958, 1959 and 1960, 39 percent, 43 and 67 percent, respectively, although on other occasions he criticizes the use of Appendix data even for trending purposes. During this same period there is no trend in the ratios of the Appendix small producers. That three years is too short a period to establish a trend for this purpose is shown by the downward movement in 1961 for both the JAS and the Chase-Census ratios. In March 1962 there were large sales of offshore leases, and the 1962 data will probably reflect this, but the whole picture still indicates variability but no trend. Sherwin's estimate,

being based largely on the least representative data, is rejected.

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Witness Park combines his estimate for lease acquisitions with that for lease facilities. He estimates that these two items should amount to 50 percent of his already determined drilling costs per Mcf. Park's estimate is based in large part on his judgment and experience as an official of Texaco. He considered the JAS average results for these items for the years when this survey was published and the 1956-60 Staff average results for all Appendix B producers. Both show a ratio of 59 percent for lease acquisition costs and lease production facilities in relation to drilling costs. Park first adjusts this percentage downward to reflect the fact that lease production facilities are more extensive on oil leases. He then adjusts the percentage upward to a lesser extent to take account of the fact that gas wells are more widely spaced and drain a greater acreage than oil wells. These two judgment adjustments resulted in a net downward adjustment to 50 percent, of which Park assigns 40 percent for lease acquisitions and 10 percent to lease production facilities.

Park's 40 percent figure is higher than the JAS average ratio. Moreover, as previously noted, the JAS was not published for the years which the Chase-Census and Appendix ratios indicate were the two lowest in their respective series, 1957 and 1958. And, as previously noted, the JAS average is probably too high because it is overweighted by large companies whose acquisition

costs are a higher proportion of well drilling costs than is true for the small companies. The average ratio for the years 1956-60 for all the Appendix B companies is 42 percent. The upward bias in the ratios resulting from the unrepresentativeness of Staff's companies has been discussed.

Park's upward adjustment is based on his experience that the spacing of gas wells is typically wider than for oil and therefore uses more acreage. He also gives his opinion that gas acreage is not correspondingly cheaper than oil acreage. He cites no study or data in support of his conclusion. He does not appear to have considered the relative values of oil or gas prospects. Park does not mention the factor that the drilling cost for gas wells is typically greater than for oil wells because of the greater depth of gas wells. This would tend to offset the effects in the relationship of possibly higher acquisition costs for gas acreage.

The record contains a single study which indicates that the cost of lease acquisitions for gas has not exceeded those for oil. In Schedule 7 of his Exhibit 224, Roseman relates the capital accounts for lease investment to the investment in lease and well equipment plus drilling cost for successful wells, classified by lease types. In other words he takes the gross historical investment in lease acquisitions for successful gas aid oil leases, and relates this amount to the corresponding gross historical investment in successful wells and lease equipment. The study shows that lease acquisition investment was 22 percent for gas leases and 20 percent for oil leases. There

is no dispute that lease facility costs on successful oil leases are generally considerably greater than on gas properties. Hence it is probable that if the ratios were limited to the capital accounts for lease acquisition and successful wells, excluding the lease facilities, they would show that the ratio for gas leases was the same as or lower than for oil leases. In any event, the study indicates that the ratio of investment in lease acquisitions to total investment for successful leases is not significantly greater for gas than for oil. This study covers productive leaseholds only. The witness concludes that this limitation doesn't affect the comparison. There is no reason to expect that the respective ratios for oil and gas leases would be changed if leaseholds which are acquired and never go into production were to be included.

There is no evidence that recent investment in gas or oil leases would change the above ratios.

While not conclusive, this study indicates that it is a reasonable hypothesis that the ratio of lease acquisition costs to drilling costs is not significantly different for gas than for oil leases.

It is concluded that Roseman's estimate based on the Chase-Census ratio furnishes the most reasonable estimate for lease acquisition costs. Applying Roseman's ratio to his drilling costs yields 0.76 cents.

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An analysis of the percentages in the table at the bottom of page 2 of this appendix setting out ratios of lease

acquisition costs to successful well costs indicates additional grounds for supporting the presiding examiner's determination of lease acquisition costs. As the examiner noted, in each year for which JAS percentages are available they correspond closely to the Roseman percentages. In 1955 the two figures were the same; in 1956 the JAS figure was one percentage point higher; in 1959, 1960, and 1961 the JAS figure is higher by two percentage points. For 1957 and 1958 no JAS figures are available but the close correlation of the figures of JAS and Roseman for the years in which data is available would indicate that if JAS figures had been available for 1957 and 1958, they would have been close to the Roseman figures of 20 percent for 1957 and 23 percent for 1958. This would indicate than an average of the available JAS figures would be misleading and that a more representative average could be obtained by including figures for 1957 and 1958, based on the observed relationship to Roseman's figures. With this adjustment, the average of the JAS figures would be 28.5 percent, as compared with the 33 percent which is the average of JAS figures actually available. It seems clear therefore that the Roseman figures of 26.4 are not too low and we agree with the examiner that they should be accepted for the purpose of computing the lease acquisition cost.

APPENDIX C, Docket Nos. AR61-1, *et al.*

DETAILED ISSUES IN COMPUTING THE COST OF OLD GAS-WELL GAS

In this appendix we shall discuss in more detail several of the issues raised in connection with the historical cost of service determination of the cost for flowing gas at pages 78-89.

Gas-Well Gas Produced from Combination Leases

Basic to the determination of production costs for old gas-well gas is the question of which lease categories should be included in the determination of such costs. There is no controversy over the inclusion of leases covering dry gas as well as gas condensate with and without lease separation. An issue has been raised, however, with respect to the inclusion of the so-called "combination lease", a term used to classify leases producing, or capable of producing, from both oil and gas reservoirs.

In computing its composite cost of gas-well gas, the Staff included data relating to gas-well gas from the combination leases for both production costs and for its E&D allowance. The producers concur in Staff's method insofar as it relates to E&D but contend that data from combination leases should be excluded from consideration in the production expenses and investment costs of gas-well gas because they involve unnecessary and unreliable additional allocations. The examiner pointed out that large amounts of gas-well gas are produced from the

combination leases and that there are economies of joint operation which should be reflected in the costs.

Our decision to base the price of flowing gas upon the cost of gas-well gas was based in part on an effort to minimize the number and complexity of the necessary allocations. Furthermore, because the liquids represent a much smaller portion of the total in gas-well gas than in oil-well gas,

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such a cost is less dependent on allocations and more nearly represents an objective cost for the gas. With this in mind we must observe that to compute the corresponding production expenses and investment costs attributable to gas-well gas on the combination leases will require two distinct stages of allocations. The first stage is to divide the combination lease costs between all gas and all liquids by the use of the relative cost method. This must be done for all gas-well gas. However, there must then be a further breakdown of the costs assigned to gas between dry gas, condensate gas, with and without lease separation, and casinghead gas. This is a complex process, involving allocation formulas which are necessarily subject to dispute. Only when this step is taken can costs related to gas-well gas from combination leases be computed. If combination leases are excluded from the compilation of production costs the more complex two-stage allocation is avoided.

To utilize the costs of combination leases in determining production costs would involve the additional allocations which we believed should be avoided and would

thus defeat a major purpose of limiting the cost to non-associated gas. There is nothing in the record to support the examiner's suggestion that somehow gas-well gas can be produced more economically on a combination lease. We believe the production expense and investment data for gas-well leases which cover some two-thirds of the gas-well gas produced in the area is fully representative of the costs for gas-well gas. Accordingly, combination leases will be excluded from the production cost computation of gas-well gas.

The use of combination leases in the computation of E&D, however, presents no further allocation problem. There are no E&D expenses directly associated with the combination leases. All that is needed to make the E&D computation are the volumes of liquid and gas produced from each type of well, and such volumes are available. Accordingly, we find that the data from the combination leases should be included in the calculation of E&D, which is consistent with the positions taken by both staff and respondents.

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Allocation of Overheads

In addition to the costs directly associated with the producing leases there are certain costs which are incurred in connection with the producers' overall activities. These are corporate general costs and expenses, area and district costs and expenses, prepaid taxes and insurance, corporate general net investment, area and district net investment, and materials and supplies. Such overheads must first be allocated between operating functions (such

as production and E&D), then between lease types, and finally between the gas and liquid products. There is no controversy about the allocation between operating functions, which was performed in most instances by the reporting companies themselves. The specific issue concerning these overhead expenses is the allocation of such costs between the various types of leases.

The Staff allocated these overhead expenses to leases on the basis of direct lease costs and expenses, exclusive of DD&A (depreciation, depletion and amortization) for items which are expensed, and on the basis of relative gross investment in the leases for capital items and the materials and supplies. On the other hand the Major Producer Group would add DD&A to the direct lease cost and expenses as a basis for allocating the common, or overhead, expenses and would use net investment in the leases as the basis for allocating capital items and the materials and supplies.

The examiner adopted staff's methods of allocation, and we affirm the examiner's finding. First, as to the issue whether the overhead expenses should be spread over all of the direct expenses including DD&A, it is clear that they should not. Overhead expenses are largely supervisory expenses and have no bearing on DD&A, which are bookkeeping entries to reflect the use of the investment. They should be allocated on the basis of direct expenses being supervised, which are exclusive of DD&A.

The second question is whether to use gross or net investment as the basis for allocating capital items and materials and supplies, two of the items in the overhead

category. In allocating the common investment items, gross investment more closely reflects management supervision than net investment which is affected by the amount of gas or oil already produced. The same is true for materials and supplies because such expenses continue regardless of whether the investment has been reduced by depreciation and depletion. We shall, therefore, allocate these two items on the basis of gross investment.

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Reinjected Volumes

An important question relating to the volumes used in computing the cost of flowing gas is the treatment of gas that is produced from the well, but is reinjected for the purpose of improving operating efficiency and increasing the recovery of liquids. If the reinjected volumes are included the effect is to reduce the unit cost of gas sold below what it would have been if costs were applied only to volumes sold, and the volumes produced but reinjected were disregarded. This is true because the same costs would be spread over a greater volume.

Respondents maintain that reinjection operations relate only to cash production expenses, and that except for these expenses all other costs should be computed on the basis of the volumes sold, which would be a smaller volume (and at higher cost) than if the total volume produced including the volumes subsequently reinjected were used. On the other hand staff maintains that all costs — cash productions cost, DD&A, return on investment

and exploration costs — should be applied to total volumes produced regardless of their disposition.

The use of total production volume, rather than sales volume, in computing the cost per Mcf assures that the share of total production costs related to the liquids derived from reinjected gas are in fact borne by liquids. For example, costs of recycling include investment in reinjection wells and other equipment, which should be borne by the liquids. In our opinion the use of production volumes, an approach which was adopted by the examiner, is the proper one. The cost of obtaining the liquids is not confined to the current expense of lifting, processing, and reinjecting the gas; all the other expenses, such as production investment and the like, are necessary as well. If they were not incurred, there would be no gas to recycle for the benefit of the liquids.

The conclusion is in accord with our prior decision on this issue in *H. L. Hunt, et al.*, 28 FPC 897 (1962). In that case the Commission stated that production volumes rather than sales volumes should be used in cost computation, and specifically mentioned recycled gas as included in production volumes.

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* * * For example gas that is recycled, gas used for off-lease purposes, gas used by other departments in drilling or production, and gas shifted to company gathering systems or plants all represent situations in which substantial volumes of gas may have been produced but would not be included in sales volumes.

The overstatement of the unit cost of single product gas inherent in the use of sales volumes also distorts the allocation of joint product costs. For example it is obvious that under the relative cost method too much of the joint production costs will be allocated to gas if the production cost of gas-well gas has been overstated. [.902]

Application of Relative Cost Method

A. *General Approach*

As a preliminary matter we are confronted with a dispute over methodology. Phillips' Witness Cramer presented a variant of the relative cost method which has been referred to as the "Y" Ratio method. The relative cost method relies on an allocation ratio based on single product costs, but the "Y" Ratio method includes in its base the costs and production of joint products, which are the very costs to be allocated by the ratio to be derived.

The "Y" Ratio method requires the use of a cubic equation and results in a mathematical formulation that is solved with a computer. Complicated formulas, even mathematical ones, do not necessarily produce meaningful results. We are persuaded that the method proposed by Witness Cramer creates only an illusion of precision and is less meaningful than the relative cost method of allocation. Under these circumstances we agree with the examiner that no reason has been shown to adopt this method.

In applying the relative-cost method there are three detailed issues on which staff and the producer-respondents differ. One is whether gas condensate leases should be included in the gas leg, a second is whether shut-in

leases should be included in the oil and gas legs, and the third is whether the joint products should be allocated on the basis of gross investment rather than on the basis of net investment.

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B. *Gas Condensate Leases*

The Staff in deriving a gas leg added to the dry gas leases, the gas-condensate leases without lease separation but excluded the gas-condensate where lease separation occurred. Respondents argue that all condensate gas, both where lease separation took place and where it did not, should be included in the gas leg. In support of their position respondents urge that there is no difference from an operating and well investment standpoint between gas condensate leases and the dry gas leases which were included, and that all the gas condensate leases should be included to reflect representative conditions relating to production on joint product leases, because otherwise the gas leg is too small to be representative.

Essentially the respondents argue that all gas condensate production should be included in the gas leg because gas condensate and dry gas leases are similar. Their argument misses the point. Obviously if there is sufficient dry gas to provide a representative gas leg, no gas condensate at all should be added. If not, the issue is the extent to which gas-condensate lease types need be added to achieve representative conditions.

Producers responding to the Commission questionnaire for the major producers (Appendix B) produced

41,652,569 Mcf of dry gas in the Permian Basin in 1960, about 4 percent of their total gas production in that area. In computing the Permian Basin gas leg of such producers, staff added to this dry gas production 1,271,495 Mcf of gas-condensate gas produced by them from leases without lease separation.

In the past, in cases dealing with individual companies, the Commission has considered that a dry gas leg representing as little as 4 percent of the total gas production of a company was an inadequate sample, and has indicated that there should be added to the gas leg a portion of the gas condensate production for the purpose of obtaining a larger sample. *H. L. Hunt, et al., supra; Hunt Oil Company, et al., supra; Union Producing Co., et al., supra.* In none of these cases, however, did the amount of dry gas production approach

the 41,652,569 Mcf of dry gas which would be the sample here if the gas leg were restricted to dry gas. Also, in the three cases cited, we were dealing with the nationwide production of individual companies and the only practicable method of enlarging the sample was to depart from a strictly single product leg and include a portion of the company's gas condensate production. In the present proceeding, however, if it were determined that the 41,652,569 Mcf of dry gas produced by the major producers in the Permian Basin were an inadequate sample it would still be possible to maintain an all dry gas leg by using the national production of dry gas by the same

companies. Although the nationwide production of dry gas by these companies is only approximately 13 percent of their total gas production, it amounts to 862,395,237 Mcf annually, a production several times larger than all of that used in computing the gas leg in *Phillips Petroleum Company, supra,* (226,681,178 Mcf). There is no question that the 862,395,237 Mcf is a sufficient volume for an adequate sample.

The total costs allocated to gas by the relative cost method vary only in a negligible amount, whether national production or Permian Basin production of dry gas is used as the sample. The Staff's inclusion of gas condensate without lease separation also has little effect. The computations of production costs are as follows:

Type of gas leg used	Gas-well gas Costs in Cents per Mcf (at 12% rate of return)
Nationwide Dry Gas Production[1]	9.136
Permian Basin Dry Gas Production	9.157
Permian Basin Dry Gas + Gas Condensate Without Lease Separation	9.161

[1] This computation has been made using Permian Basin cost data but applying an allocation ratio derived from national statistics. We reassert that for flowing gas the area costs are to be used in computing production costs. The use of the national dry gas volumes would be for the sole purpose of developing allocation ratios.

It will be noted that the costs, as computed on the basis of an allocation ratio derived from national production, differ by approximately .02 cent per Mcf from the compu-

tation of such costs derived from the ratio of dry gas production in the Permian Basin, and that the ratio derived from Permian Basin production is more favorable to the producer-respondents. The computation actually used by the Staff, which included gas condensate without lease separation in determining the allocation ratio, varies from the determination made on the basis of the Permian dry gas only by approximately .004 cent, and, again, the miniscule difference is favorable to the producer-respondents.

We think that if there is an insufficient area dry gas leg the use of national dry gas production would be preferable to the inclusion of gas condensate production for the purpose of determining the allocation ratio. However, where an area gas leg is derived from dry gas volumes of 41,652,569 and where the use of national dry gas production would produce a result equivalent to use of the area dry gas production, we believe it is proper to use the area production leg. Since the inclusion in the gas leg of the small amount of gas condensate by staff resulted in such an insignificant difference in cost, for the purposes of this case we will adopt Staff's computation. Regardless of which of these two computations we choose, it would not alter the cost sufficiently to affect the price of old gas-well gas as herein determined.

C. *Shut-in Leases*

Staff in computing its gas leg and oil leg excluded shut-in leases for purposes of determining the allocation percentages, although the actual cost of the shut-in leases in the joint lease category is, of course, included in the

joint cost when the allocations are applied. Respondent-producers contend that shut-in leases should be included in determining the allocation percentages, because they are part of the cost of producing gas and shut-in oil leases are part of the cost of producing oil. The issue has been previously determined by this Commission. "Non-producing properties should not be included in ascertaining the oil and gas legs for allocation of the joint production costs." *Hunt Oil Co., et al.*, 28 FPC 623, 624 (1962). Shut-in lease costs are not representative of the production costs of either gas wells or oil wells because they are essentially non-producers. Their inclusion in the oil and gas legs would distort an otherwise representative single product cost factor and thus defeat the underlying principle behind the relative cost allocation method.

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D. *Gross or Net Investment*

In computing the gas leg and oil leg for determining the relative cost of the joint production, the separate costs of each product must include an element of return on investment. Rather than using net investment, Staff would allocate the return allowance on the joint production on the basis of gross investment in leases producing separate single products. Respondents would use net investment. They argue that the use of gross investment overlooks the fact that this particular use of the relative cost theory is applied to production investment for the sole purpose of computing a return on investment, and

that such return is computed on net investment, not gross investment.

The fact that the purpose of the allocation is to compute a return on investment is irrelevant, the test being which method more nearly reflects the operating facts of the joint production. The basic fact which raises the issue between gross and net investment is that oil-only leases are generally more depleted than dry gas leases.[2] Thus, using net investment would tend to assign less cost to oil and more to gas than if gross investment is used. On joint product leases (except some combination leases), the depletion rate is the same for liquids as for gas. Allocation on the basis of the gross investment more nearly reflects that fact. If net investment is used as the basis for the allocation it would impose a comparatively greater burden on gas than oil because of the relatively lower net investment of the oil-only leases which are more depleted. Its use would not reflect the true state of affairs on many joint product leases. We shall, therefore, use gross investment for this allocation.

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Lease Play Allowance

In our calculation of working capital for new gas, we included an additional allowance for lease play over and above the working capital allowance which would be

[2] Oil leases average 62 percent depletion, nationally, and 55 percent in the Permian Basin, contrasted with an average depletion for dry gas leases of 40 percent nationally and 37 percent in the Permian Basin.

justified under the traditional utility method.[3] The question arises as to whether this additional allowance should be permitted in the cost computation for flowing gas. In *Hunt Oil Company*, 28 FPC 623 (1962) and in *Union Producing Company*, 31 FPC 41 (1963) the Commission denied lease play allowances on the ground that since a year-end rate base was being utilized such an allowance was unwarranted. The rationale for this finding was that any money expended to obtain leases during the year would receive a full year's return, even though such properties may have been purchased late in the year. These cases were not precedents for excluding a lease play allowance under our new gas calculation since an average-year rate base and not a year-end rate base was being used. However, in the development of our composite cost of service for flowing gas, we are using a year-end rate base. Accordingly, in view of the findings made in the *Union Producing* and *Hunt* cases no additional allowance for lease plays is included in the cost calculation for flowing gas.

[3] In our computation of the new gas cost, there is a separate classification for working capital. In the development of a composite cost of service the working capital allowance is not set out separately but is combined with investment in property under the separate cost computation for production cost and E&D cost.

Computation of E&D Allowance

The Commission utilized the modified Btu method in allocating E&D costs. In its application of this method the Commission used an economic factor of 3.5 for lease liquids and 1.0 for all gas. The E&D costs related to the Appendix "B" respondents are set out on the following page of this appendix. The results are summarized below.

E&D Allocated to Gas-Well Gas

	Cost (Return at 12%)	Unit Cost (Return at 12%) ¢ per Mcf
Expense	$167,036,961	3.46¢
Return[4]	30,010,322	0.62
	$197,047,283	4.08¢

[4] In the costing of old gas, certain costs classified as E&D costs are "capitalized" and made part of an E&D rate base, while certain items are "expensed." In deriving the cost of new gas, no items except "expensed" items were classified as E&D, and, therefore, no separate E&D rate base was developed. All new gas cost items which were capitalized, regardless of whether they were applicable to E&D or production, were put into the production investment rate base. This distinction between old and new gas is one of accounting classification. The final cost computation under either method is not affected by this difference.

Allocation of Appendix "F" Nonconsents' R & D Costs Using Economic Factors Of 3.5 For Liquids and 1.0 For All Gas

(1)	Volume 1/ Lease Liquids (Bbl) (2)	Volume 1/ Gas (Mcf) (3)	Unit Btu's 1/ (Million Btu Per Bbl or Mcf) (4)	Total Btu's 1/ (Million Btu's) (5)	Economic Factor (6)	Adjusted Btu's (Million Btu's) (7)	Allocated Expenses Amount 2/ ($) (8)	Allocated Expenses Unit (¢/Bbl or Mcf) (9)	Allocated Return Allowance Amount 2/ ($) (10)	Allocated Return Allowance Unit (¢/Bbl or Mcf) (11)	Allocated Expenses & Return Allowance Amount ($) (12)	Allocated Expenses & Return Allowance Unit (¢/Bbl or Mcf) (13)
Net Working Interest												
Oil Only Leases												
Lease Liquids	328,551,309	—	5.812	1,909,253,251	3.5	6,732,386,378	214,390,638	65.253	38,518,014	11.724	252,908,652	76.977
Raw Gas	—	36,330,206	1.233	44,795,144	1	44,795,144	1,122,242	3.915	255,527	0.703	1,377,769	4.618
Oil Casinghead Gas Leases												
Lease Liquids	689,970,938	—	5.811	4,009,417,339	3.5	14,032,960,687	445,551,429	64.575	80,018,999	11.602	525,600,428	76.177
Raw Gas	—	1,130,393,895	1.272	1,438,235,594	1	1,438,235,594	53,729,074	4.039	9,653,114	0.726	63,382,188	4.764
Gas Only Leases												
Lease Liquids	48,650	—	5.426	263,968	3.5	923,888	29,334	60.296	5,270	10.832	34,604	71.128
Raw Gas	—	862,395,237	1.042	898,615,837	1	898,615,837	28,531,368	3.308	5,126,024	0.594	33,657,392	3.903
Gas-Condensate Lease Separation Leases												
Lease Liquids	44,298,134	—	5.412	239,364,539	3.5	837,775,886	26,599,679	60.112	4,778,972	10.505	31,378,651	70.847
Raw Gas	—	2,378,113,786	1.089	2,589,220,608	1	2,589,220,608	82,208,664	3.457	14,769,836	0.621	96,978,500	4.078
Gas-Condensate No Lease Separation Leases												
Lease Liquids	2,501,136	—	5.053	12,639,463	3.5	44,238,121	1,404,576	56.158	252,350	10.089	1,656,926	66.247
Raw Gas	—	544,137,588	1.148	647,615,435	1	647,615,435	20,562,017	3.645	3,694,229	0.655	24,256,246	4.300
Combination Leases												
Lease Liquids	134,254,958	—	5.771	1,121,075,663	3.5	3,923,764,785	124,580,910	64.133	22,382,550	11.522	146,963,460	75.655
Raw Gas Produced From Oil Wells	—	532,497,793	1.187	632,312,278	1	632,312,278	20,076,137	3.769	3,606,934	0.677	23,683,071	4.446
Raw Gas Produced From Gas Wells	—	147,813,158	1.091	161,268,155	1	161,268,155	5,120,194	3.464	919,908	0.622	6,040,102	4.086
Raw Gas Produced From Gas-Cond. Wells	—	878,908,057	1.102	968,232,411	1	968,232,411	30,616,718	3.483	5,500,395	0.626	36,117,113	4.109
Sub-Total, Raw Gas, Combination Lease.	—	1,559,219,008	1.130	1,761,808,844	1	1,761,808,844	55,811,049	3.581	10,027,237	0.643	65,838,286	4.224
Sub-Total, NGT, Lease Liquids	1,359,555,109	—	5.805	7,312,614,213	3.5	25,592,149,765	812,956,566	64.511	145,986,155	11.590	958,942,721	76.102
Raw Gas	—	6,726,845,718	1.134	7,630,291,482	1	7,630,291,482	242,261,434	3.601	43,525,897	0.647	285,790,331	4.249
Royalties Received, Lease Liquids	22,522,451	—	5.805	130,748,135	3.5	457,618,473	14,529,847	64.511	2,610,118	11.590	17,139,965	76.102
Raw Gas	—	180,295,367	1.134	204,509,849	1	204,509,849	6,493,259	3.601	1,166,597	0.647	7,659,856	4.249
Total, Lease Liquids	1,382,077,560	—	5.805	7,443,362,348	3.5	26,049,768,238	827,486,133	64.511	148,596,273	11.590	975,682,686	76.102
Raw Gas	—	6,907,141,085	1.134	7,834,801,331	1	7,834,801,331	248,754,693	3.601	44,692,494	0.647	323,450,187	4.249
	1,382,077,560	6,907,141,085		15,277,563,679		33,884,569,569	1,076,240,826		193,288,767		1,269,133,873	
Appendix "F" Gas-Well Gas Computation 3/		4,847,143,896					167,036,961	3.160	30,010,322	0.622	197,047,283	4.082

1/ Volume and Btu's obtained from Exhibit No. 170, Schedule Nos. 8(A) and 9(A).
2/ Total Distributed on basis of adjusted Btu's in Column (7).
3/ Total Expense data obtained from Exhibit No. 168, Schedule No. 7.
4/ Return Allowance data obtained from Exhibit No. 168, Schedule No. 6, Line 33 times 12%.
5/ Summary of Gas-Well Gas Costs as computed by combining applicable costs related to Gas Only Leases, Gas Condensate with Lease Separation Leases, Gas Condensate No Lease Separation Leases, and Combination Leases.

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RATE SCHEDULE - QUALITY STATEMENT

1. APPLICABLE SECTION 4(e) DOCKET NO(S). (If any) (Use space below if needed)

2. PRODUCER NAME

3. RATE SCHEDULE NO.

4. TYPE OF GAS (Check one)

A. ☐ NEW GAS-WELL GAS *
B. ☐ RESIDUE GAS DERIVED FROM NEW GAS-WELL GAS
C. ☐ RESIDUE GAS NOT DERIVED FROM NEW GAS-WELL GAS
D. ☐ OLD GAS-WELL GAS
E. ☐ CASINGHEAD GAS
F. ☐ MIXED GAS (Give proportion of types A and B) _____

5. PLACE OF PRODUCTION (Give State, County, Field and Municipality)

6. QUALITY OF GAS	PRODUCER'S STATEMENT OF QUALITY AND TREATING COSTS		BUYER'S STATEMENT OF QUALITY AND TREATING COSTS (If same as producer, indicate by check mark)	
	CONTENT OR PRESSURE	COST PER MCF OF TREATING GAS TO PIPELINE STANDARDS	CONTENT OR PRESSURE	COST PER MCF OF TREATING GAS TO PIPELINE STANDARDS
A. HYDROGEN SULPHIDE CONTENT (In grains per Mcf)...				
B. TOTAL SULPHUR CONTENT (In grains per Mcf).....				
C. CO_2 CONTENT (Percentage of volume sold).....				
D. H_2O CONTENT (In pounds per Mcf).....				
E. CONTENT OF OTHER IMPURITIES (Indicate whether above or below customary commercial and pipeline standards).....				
F. ACTUAL DELIVERY PRESSURE (Pounds per square inch)				
G. TOTAL				
H. BTU CONTENT PER MCF (New gas well gas only).....				

7. APPLICABLE AREA CEILING RATE _____ cents per Mcf

8. BTU PRICE ADJUSTMENT * (State whether plus or minus) _____ cents per Mcf

9. APPLICABLE RATE (Ceiling rate less treating costs, with Btu adjustments if any *) _____ cents per Mcf

10. RATE HERE ESTABLISHED (Not above applicable ceiling rate as adjusted) _____ cents per Mcf

NOTHING HEREIN SHALL PREVENT THE SELLER FROM FILING FOR ANY INCREASED RATE PERMITTED BOTH BY THE CONTRACT (IN THE ABSENCE OF THIS STATEMENT) AND BY APPLICABLE ORDER OF THE FEDERAL POWER COMMISSION.

12. SIGNATURE OF SELLER, AGENT OR OPERATOR

11. DATE OF STATEMENT

13. SIGNATURE OF BUYER

NOTE:
THE TERMS HEREIN ARE THOSE USED IN THE OPINION OF THE FEDERAL POWER COMMISSION IN PERMIAN BASIN AREA RATE PROCEEDING, AR61-1. NEW GAS-WELL GAS IS NATURAL GAS DERIVED FROM GAS WELLS MOVING UNDER CONTRACTS DATED ON OR AFTER JANUARY 1, 1961. THE BURDEN IS UPON A PRODUCER TO ESTABLISH THAT PARTICULAR GAS IS NEW GAS-WELL GAS OR RESIDUE GAS DERIVED THEREFROM, AND ALSO TO ESTABLISH THE PERCENTAGE OF SUCH GAS PRESENT IN A SALE OF MIXED GAS.

* Btu price adjustment to be applied in case of new gas well gas only.

APPLICATION FOR SMALL PRODUCER CERTIFICATE OF PUBLIC CONVENIENCE AND NECESSITY

(Section 157.40 of Regulations)

NOTE: Independent Producers of natural gas whose total jurisdictional sales on a nationwide basis for the preceding year, combined with those of " affiliated producers, " were not in excess of 10,000,000 Mcf may file the information called for in the following format (in four copies, to the Federal Power Commission, Washington D.C., 20426.) Include volume of gas paid for but not taken under prepayment clauses or otherwise, and volumes of gas sold under other independent producer rate schedules in the proportion that the independent producer seeking to come with Section 157.40 has an interest in such sales. Do not include sales made pursuant to percentage sales contracts. If insufficient space is given for a complete answer, continue the answer on the reverse side, noting the relevant number.

1. NAME OF APPLICANT

2. STATE OF ORGANIZATION

3. LOCATION OF PRINCIPAL PLACE OF BUSINESS

4. TYPE OF ORGANIZATION (Corporation, partnership, joint venture, etc)

5. NAMES OF STATES IN WHICH AUTHORIZED TO DO BUSINESS

6. NAME, TITLE AND MAILING ADDRESS OF PERSON RESPONSIBLE FOR APPLICATION

NAME AND TITLE

MAILING ADDRESS

7. TOTAL JURISDICTIONAL SALES VOLUMES AT _____ PSIA FOR PRECEDING YEAR

8. LIST ALL CERTIFICATES PRESENTLY HELD BY DOCKET NUMBER AND ALL CONTRACTS ON FILE WITH THE COMMISSION AS RATE SCHEDULES BY RATE SCHEDULE NAME AND NUMBER

9. IF APPLICANT DOES NOT HAVE ANY OUTSTANDING CERTIFICATES ISSUED BY THE COMMISSION FOR THE SALE OF GAS, LIST FOR EACH JURISDICTIONAL SALE OR TRANSPORTATION CONTRACT: (A) NAME OF PURCHASER; (B) SOURCES OF PRODUCTION BY STATE, COUNTY AND FIELD; (C) ANNUAL CONTRACT VOLUME DELIVERY OBLIGATION (Indicate psia per Mcf); (D) TOTAL PRICE PER MCF AT TIME OF FILING

10. LIST ALL OWNERS OF MORE THAN 5 PERCENT INTEREST IN APPLICANT: (A) INDIVIDUAL NAME; (B) PERCENT OF OWNERSHIP

11. LIST ALL INTEREST OWNED BY THE INDIVIDUALLY NAMED OWNERS IN OTHER NATURAL GAS COMPANIES: (A) INDIVIDUAL NAME; (B) COMPANY NAMES; (C) PERCENT OF OWNERSHIP

12. LIST ANY POSITIONS HELD BY THESE INDIVIDUAL OWNERS IN APPLICANT COMPANY OR ANY OTHER NATURAL GAS COMPANY

13. IS APPLICANT OR ANY INDIVIDUAL OWNER LISTED, AFFILIATED WITH ANY PURCHASER OF JURISDICTIONAL GAS FROM APPLICANT (If so list name of buyer and seller for each such sale and nature of affiliation)

14. LIST ALL OWNERS OF MORE THAN 1/8TH INTEREST IN EACH GAS SALE CONTRACT TO BE COVERED BY THIS CERTIFICATE AND THE AMOUNT OF THEIR INTEREST.

SIGNATURE	TITLE	DATE

(Use reverse side for additional comments and identify)

277,801

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Before Commissioners: Joseph C. Swidler, Chairman;
Lawrence J. O'Connor, Jr.
Charles R. Ross;
David S. Black;
Carl E. Bagge.

	Docket Nos.
Area Rate Proceeding	AR61-1, *et al.*
North Central Oil Corporation (Operator), *et al.*	CI60-435
Socony Mobil Oil Company, Inc.	CI61-34
Robert T. Brown (Operator), *et al.*	CI61-733
Texaco Inc.	CI61-879

ORDER ISSUING CERTIFICATES
(Issued August 5, 1965)

By Opinion No. 468 and order in this proceeding issued concurrently with this order we have prescribed the just and reasonable rates for jurisdictional sales of natural gas in the Permian Basin area. There are four applications for certificates of public convenience and necessity which were consolidated in this proceeding and these are the subject of the present order. Temporary certificates have been granted to all four applicants and the gas is now flowing in interstate commerce.

The only issue presented by the applications is the initial price at which the gas is to be certificated. As we stated in Opinion No. 468, the just and reasonable area rate fixed therein constitutes the "in line" price required

by the public convenience and necessity in granting permanent certificates. All of the applications involve "flowing gas" as defined in Opinion No. 468, produced in Texas. The applicable area rate is 14.5 cents per Mcf at 14.65 psia adjusted to reflect any quality deficiencies in the gas and we shall therefore grant the certificates conditioned to an initial price no higher than the applicable area rates. The certificates shall be subject to the moratorium on any rate increase filing in excess of the applicable area rate prior to January 1, 1968, as provided in Opinion No. 468, pp. 107-113.

277,802

Each of the certificate applications has a somewhat different history from the others and also differs in its contract provisions. We shall therefore discuss each of them separately.

The proposed rate schedule of *North Central Oil Company* (Operator), *et al.*, Docket No. CI60-435, contains provisions specifying that the gas must equal or exceed in every particular the pipeline quality standards established in Opinion No. 468. A permanent certificate will therefore be issued in this docket providing for an initial price of 14.5 cents per Mcf at 14.65 psia. The temporary certificate contained no refund condition but a rate increase was filed during the period of the temporary. The increased rate was suspended pursuant to Section 4(e) and has subsequently been collected subject to refund, Docket No. RI65-288. The last-mentioned docket has not been consolidated herein and accordingly the question of refunds in that proceeding will be disposed of

pursuant to the Order to Show Cause issued this date. The question of whether refunds should be ordered during the period of the temporary when no express refund obligation was operative, but prior to the effective date of the proposed increased rate, will be deferred until our decision of the same issue in Skelly[1] and Amerada[2].

Robert T. Brown (Operator), et al., Docket No. CI61-733 involves sales made under a temporary certificate without an express refund condition. The related contract contains provisions requiring gas moving under it to equal or exceed pipeline quality standards in all respects save for hydrogen sulphide and total sulphur. The permanent

certificate will provide for an initial price computed by modifying the ceiling price of 14.5 cents per Mcf by deducting therefrom the cost of processing the gas to meet the pipeline quality standards for the Permian Basin. Accordingly the producer (unless these sales qualify as small producer sales as defined in the rule proposed this date providing for small producer certificates for such sales) shall, within 90 days of the effective date of this order, file a statement which shall state either that the gas accords with all pipeline quality standards established in Opinion No. 468 or in which respects the gas deviates from such standards, the agreed cost to the buyer of processing the gas to bring it to the quality standards with

[1] Skelly Oil Company, Docket Nos. G-18638, *et al.*

[2] Amerada Petroleum Corporation, *et al.*, Docket Nos. CI62-1544, *et al.*

respect to each quality defect, and the resulting rate for the gas. Such statement shall be signed by both seller and buyer. However, if the seller and buyer are unable to agree upon any or all of the particulars entering into the computation of the proper price, the seller must so indicate in the statement and supply the information required to compute the applicable area rate as adjusted as well as the contentions of the parties with respect to the quality and amount of the adjustment as any item in dispute. The buyer may file a separate statement setting forth its views within such period. In such event the Commission will then determine the amount of the quality deduction. As in the case of *North Central Oil Corporation (Operator) et al., supra,* the determination of any refunds which may be due for the period of the temporary, when no express refund conditions were in effect, shall be deferred.

The applications of *Socony Mobil Oil Company, Inc.,* (Socony), Docket No. CI61-34, and *Texaco Inc.,* Docket No. CI61-879, involve so-called Spraberry or El Paso contracts. In accordance with the principles established in Opinion No. 468, the applicable area rate will be applied to the volumes of residue gas taken into the purchaser's pipeline under these contracts. The contracts provide that there shall be a reduction in the price paid for such residue gas if treatment of the casinghead stream received by the buyer is necessary to remove sulphur. The cost of such treatment and the cost of any other necessary treatment of the casinghead stream to bring the gas to pipeline quality, aside from those processing costs incurred in removing the liquids, must be deducted

from the ceiling price of 14.5 cents per Mcf to determine the applicable area rate. The certificates granted in these two dockets will be conditioned upon a filing by the producer within 90 days of the effective date of this order of a statement as to quality of the casinghead gas and cost

of treating (or an estimate if no agreement is reached) as described above and further conditioned upon an initial price equal to the applicable rate established by deduction from 14.5 cents per Mcf of the cost of treating the gas to pipeline quality standards as such cost is determined by agreement of the parties or by the Commission. During the time they were operating under these temporary certificates both Socony and Texaco Inc. filed for rate increases which were suspended and are now in effect subject to refund. Computations of the refunds due for the period during which these rates have been collected subject to refund will be dealt with in the Section 4(e) proceedings—Docket Nos. RI65-209 and RI65-115.

Socony succeeded to a temporary certificate which contained a refund condition. Texaco Inc. succeeded to a temporary certificate without refund condition. Accordingly, Socony will be required to submit a computation of all excess amounts collected for the entire period of operations under the temporary certificate except the time during which the Section 4(e) proceeding was pending, and to make refund of those amounts with interest. For the reasons previously stated, Texaco Inc. will not be required at this time to make any refunds for the period when there was no express refund condition.

All certificates issued herein shall be subject to a moratorium against rate increases prior to January 1, 1968, unless such increases are authorized by later order of the Commission.

The Commission finds:

(1) Each applicant for a certificate of public convenience and necessity listed in Appendix A hereto is a natural-gas company within the meaning of the Natural Gas Act as an independent producer of natural gas, as that term is defined in section 154.91(a) of the Commission's Regulations, engaged in the sale of natural gas in interstate commerce for resale for ultimate public consumption and such sales together with the construction and operation of any facilities therefor are subject to the requirements of subsections (c) and (e) of Section 7 of the Natural Gas Act.

(2) Each applicant listed in Appendix A hereto is able and willing properly to do the acts and to perform the services proposed and to conform to the provisions of the Natural Gas Act and the requirements, rules and regulations of the Commission thereunder.

277,805

(3) The sale of natural gas as proposed herein by each applicant listed in Appendix A hereto together with the construction and operation of any facilities subject to the jurisdiction of the Commission necessary therefor are required by the public convenience and necessity and a certificate authorizing the same should issue to each of them upon the terms and conditions of the order herein,

which terms and conditions are required by the public convenience and necessity.

(4) Except as granted in the order in Opinion No. 468 the exceptions of the applicants listed in Appendix A hereto to the presiding examiner's initial decision and proposed order should be denied.

The Commission orders:

(A) Certificates of public convenience and necessity are issued, upon the terms and conditions of this order, authorizing the sales by the applicants listed in Appendix A to this opinion of natural gas in interstate commerce for resale, together with the construction and operation of any facilities subject to the jurisdiction of the Commission necessary for such sales, all as hereinbefore described and as more fully described in the respective applications, amendments, supplements and exhibits in this proceeding.

(B) The certificates granted in paragraph (A) above are not transferable and shall be effective only so long as the applicants continue the acts or operations hereby authorized in accordance with the provisions of the Natural Gas Act and the applicable rules, regulations and orders of the Commission.

(C) The grant of the certificates issued in paragraph (A) above shall not be construed as a waiver of the requirements of Section 4 of the Natural Gas Act or Part 154 or Part 157 of the Commission's Regulations thereunder, and

is without prejudice to any findings or orders which have been or may hereafter be made by the Commission in any proceeding now pending or hereafter instituted by or against the respective applicants. Further, our action in this proceeding shall not foreclose or prejudice any future proceedings or objections relating to the operation of any price or related provisions in the gas purchase contracts herein involved. The grant of the certificates aforesaid for service to the particular customers involved shall not imply approval of all the terms of the respective contracts, particularly as to the cessation of service upon termination of said contracts, as provided by Section 7(b) of the Natural Gas Act. The grant of the certificates aforesaid shall not be construed to preclude the imposition of any sanctions pursuant to the provisions of the Natural Gas Act for the unauthorized commencement of any sales of natural gas subject to said certificates.

(D) The notice provisions of Section 154.94(b) and the detailed submittal subprovisions of Section 154.94(f) of the Commission's Regulations Under the Natural Gas Act are waived insofar as they apply to any reductions in rates hereby ordered.

(E) The certificate granted to North Central Oil Corporation (Operator), *et al.*, is conditioned upon a total initial price, including tax reimbursement, of 14.5 cents per Mcf at 14.65 psia, and within 30 days of the effective date of this order North Central shall file a supplement to its presently filed rate schedule reflecting the con-

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ditioned price as the initial price in lieu of the initial price provided in the present rate schedule.

(F) The certificates granted to the applicants, other than North Central Oil Corporation (Operator), *et al.*, are hereby conditioned to a total initial price, including tax reimbursement, no greater than the applicable base area rate of 14.5 cents per Mcf at 14.65 psia subject to further reductions, effective as of the effective date of this order, for any quality deviations as determined pursuant to ordering paragraph (G) hereof, and further conditioned upon the filing by the respective applicants within 30 days of the determination of such rate of a supplement to its filed rate schedule reflecting the applicable area rate in lieu of any rate provided in the rate schedule then on file, and further conditioned upon refunds being made with interest by each applicant of the difference between the applicable area rate and any rate in excess thereof collected subsequent to the effective date of this order. The manner and time of such refunds shall be determined by the Commission in a later order.

277,807

(G) The certificate hereby granted to each applicant listed in Appendix A hereto, other than North Central Oil Corporation (Operator) et al., is issued upon the condition that such applicant (unless the sale qualifies as a small producer sale pursuant to the proposed rule issued this date) shall file, within 90 days of the effective date of this order, a statement that the gas accords with all pipeline quality standards established in Opinion No. 468 or in which respects the gas deviates from such standards,

the agreed cost to the buyer of processing the gas to bring it to the quality standards with respect to each quality defect and the resulting rate for the gas. Such statement shall be signed by both seller and buyer. However, if the seller and buyer are unable to agree upon any or all of the particulars entering into the computation of the proper price, the seller must so indicate in the statement and supply the information required to compute the applicable area rate as adjusted as well as the contentions of the parties with respect to the quality and amount of the adjustment as any item in dispute. The buyer may file a separate statement setting forth its views within such period.

(H) The certificate granted to Socony Mobil Oil Company, Inc. is issued upon the condition that the said applicant shall file within 120 days of the effective date of this order a report in triplicate with this Commission of the refunds due each buyer by reason of the collection by said applicant and its predecessor of rates in excess of the applicable area rate during the period in which such excess rates were collected prior to the effective date of the rate which is the subject of the present proceeding in Docket No. RI65-209.

277,808

(I) Socony Mobil Oil Company, Inc. shall retain the amounts shown in the report required under (H) above, subject to further order of the Commission directing the disposition of those amounts. If said applicant elects to commingle these retained refunds with its general assets and use them for its corporate purposes, it shall pay

interest thereon at the rate of 7 percent per annum on all funds thus available from the date of the filing of the refund report to the date on which they are paid over to the person ultimately determined to be entitled thereto in a final order of the Commission. If the applicant elects to deposit the retained refunds in a special escrow account, the respondent shall tender for filing on or before the date of the filing of the refund report an executed Escrow Agreement, conditioned as set out below accompanied by certificate showing service of a copy thereof upon each of its jurisdictional customers. Unless notified to the contrary by the Secretary within 30 days from the date of filing thereof, the Escrow Agreement shall be deemed to be satisfactory and to have been accepted for filing. The Escrow Agreement shall be entered into between respondent and any bank or trust company used as a depositor for funds of the United States Government and the agreement shall be conditioned as follows:

(1) Respondent, the bank or trust company, and the successors and assigns of each, shall be held and formally bound unto the Federal Power Commission for the use and benefit of those entitled thereto, with respect to all amounts and the interest thereon deposited in a special escrow account, subject to such Agreement, and such bank or trust company shall be bound to pay over to such person or persons as may be identified and designated by final order of the Commission and in such manner as may be therein specified, all of any portion of such deposits and the interest thereon.

(2) The bank or trust company may invest and re-invest such deposits in any short-term indebtedness of the United States or an agency thereof or in any form of obligation guaranteed by the United States which is, respectively, payable within 120 days as the said bank or trust company in the exercise of its sound discretion may select.

(3) Such bank or trust company shall be liable only for such interest as the invested funds described in Paragraph (2) above will earn and no other interest may be collected from it.

(4) Such bank or trust company shall be entitled to such compensation as is fair, reasonable and customary for its services as such, which compensation shall be paid out of the escrow account to such bank or trust company. Said bank or trust company shall likewise be entitled to reimbursement for its reasonable expenses necessarily incurred in the administration of this escrow account, which reimbursement shall be made out of the escrow account.

(5) Such bank or trust company shall report to the Secretary of this Commission quarterly, certifying the amount deposited in the trust account for the quarterly period.

(J) The decision whether refunds should be ordered as a condition of the permanent certificate of applicants, other than Socony Mobil Oil Company, Inc., listed in Appendix A hereto is deferred for subsequent determination. Such certificates shall issue at the present time subject to the condition that the subsequent determination of the Commission with respect to such refunds shall then be incorporated in each such certificate as a condition thereof.

(K) The certificate granted to each applicant listed in Appendix A hereto is issued upon the condition that the applicant shall not file any change in rate providing for

a price in excess of the applicable area rate prior to (1) subsequent order of the Commission in this proceeding permitting such filing or (2) January 1, 1968, whichever is earlier.

(L) The certificate of each applicant listed in Appendix A is issued upon the condition that the proposed rate schedule of the applicant shall be amended by the inclusion of the following language:

> "From the effective date of the order of the Federal Power Commission in the Permian Basin Area Rate Proceeding AR61-1, until January 1, 1968, no increase in rates may be filed, except in compliance with a specific order of the Commission, at a rate in excess of the applicable area rate as determined pursuant to said proceeding or pursuant to later order of the Commission. Applicable area rate, as that term is used herein, shall mean the rate to be determined after all adjustments from the ceiling price because of deviations from the pipeline quality standards established in the aforesaid order of the Commission."

(M) Except as herein granted the exceptions to the initial decision and proposed order are hereby denied.

By the Commission.

(SEAL)

Joseph H. Gutride,
Secretary.

278,704

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Before Commissioners: Joseph C. Swidler, Chairman;
Lawrence J. O'Connor, Jr.,
Charles R. Ross, and
David S. Black

	Docket Nos.
Area Rate Proceeding	
Claud E. Aikman, *et al.*	AR61-1
North Central Oil Corporation (Operator), *et al.*	G-18466, *et al.* CI60-435, *et al.*

OPINION NO. 468-A

DENYING APPLICATIONS FOR REHEARING OF OPINION NO. 468

(Issued October 4, 1965)

SWIDLER, Chairman:

On August 5, 1965, the Commission issued its Opinion No. 468 in the above-entitled proceeding. Applications for rehearing have been filed by various parties. The applications in part consist of a repetition of contentions which were fully considered in the course of reaching the determinations embodied in Opinion No. 468. However, the applications have persuaded us that certain modifications are required in the quality standards prescribed in Opinion No. 468. In addition we wish to clarify certain findings in the opinion with respect to which questions have been raised and to respond to certain contentions not previously advanced.

Initially we note and reject the contention by the respondent Phillips Petroleum Company and by Independent Petroleum Association of America that the participation of Commissioner Black and the Chairman in the Opinion and Order herein was improper because they had demonstrated bias and prejudgment on the issue whether competition among producers can be relied upon to justify their contract prices as just and reasonable under the standards of the Natural Gas Act. Nothing which has transpired since the release of Opinion No. 447, in which we rejected an earlier motion to disqualify Commissioner Black, leads us to doubt the correctness of our

conclusion there. The views expressed therein are equally applicable to the attempt, belatedly and retroactively, to disqualify the Chairman on the basis of his speech of September 22, 1964, to the Independent Natural Gas Association of America of which we take notice.[1]

[1] Speaking personally, I am unaware of any bias or prejudgment on the issue of competition or any other issue in this proceeding. It would have been impossible for me to have worked four years as a member and Chairman of the Commission without acquiring some knowledge of the economic forces which affect natural gas pricing and forming opinions on how they operate. I have formed and expressed some opinions on the questions raised by proposed legislation to repeal FPC regulation over sales by gas producers in interstate commerce. My speech to INGAA expressed my belief that the Natural Gas Act as interpreted by the Supreme Court to apply to gas producers is necessary to protect the interests of the consuming public and made clear that on this legislative question I had not been persuaded by the arguments that competition between producers was an adequate substitute for regulation. These views on the need for producer regulation, however, did not prevent me from fairly evaluating the evidence in this proceeding bearing on the weight to be given to competition in determining the standards for fixing just and reasonable area rates. — JCS

Quality Standards

We shall now discuss three changes and clarifications which we are making in the quality standards:

Pressure

Several producer-applicants argue that the standard of 800 pounds pressure for pipeline quality gas is not realistic, pointing out that most of the gas delivered in the Permian Basin in 1960 was delivered below that pressure. We agree. While the record supports our conclusion that 800 pounds is the pressure generally employed in the principal mainline segment of the pipelines in the Permian Basin, our conclusion did not give sufficient weight to the pipeline systems operated in the Permian Basin at much lower pressure and to the

actual delivery standards in the area. Upon further consideration we believe that a pressure standard of 500 pounds would more nearly reflect the pressure at which gas is delivered to the pipeline systems in the Permian Basin.

Shell Oil Company (Shell) posed the problem of the unfairness of a quality deduction for sales of gas which the producer is ready and able to deliver at pressures higher than those at which the buyer can accept gas. We think that this point is also well taken. The delivery pressure for purposes of quality adjustments shall be the pressure at which the seller is ready and able to deliver gas into the buyers' facilities without further compression, even if such pressure must be reduced so that it can

be conveniently accepted by the buyers' established facilities at the point of delivery. Our previous order will be modified in this respect.

Btu Adjustment for Flowing Gas

In Opinion No. 468 we specified a Btu adjustment for new gas-well but did not do so for flowing gas. Upon reconsideration we are persuaded by the producers' argument that there is no adequate justification for this difference in treatment, and we agree that the price for both new gas-well gas and flowing gas should be related to its energy content. The producers correctly point out that otherwise the quality adjustments on flowing gas would operate in only one direction. There would be no upward adjustment for gas rich in energy, but which would nevertheless be subject to a downward adjustment because of excessive sulphur or low pressure. We believe the reasons stated for applying the Btu content standard to new gas-well gas apply equally to flowing gas and our previous order will be modified accordingly.

The Btu adjustment will be applied to the area base rate before price adjustments for quality. In view of the fact that a majority of contracts for gas-well gas provide for a payment for liquids removed by the purchaser, Btu content should be measured after the removal of such liquids where such payment is made.[2] To measure Btu's prior to extraction of the liquids and then pay a bonus for high Btu content in the form of liquids would be a double payment.

[2] The same principle would also apply in the case of similar contracts for residue or casinghead gas.

278,707

Carbon Dioxide Adjustments

Under Opinion No. 468 a producer with gas containing excessive amounts of carbon dioxide is paid on the basis of the volume of gas remaining after deduction of the above standard volumes of carbon dioxide. The application of the Btu adjustment provision to flowing gas makes possible a somewhat simpler handling of rates in contracts containing a high percentage of carbon dioxide. In addition to the method described above, we can now provide the producers with the alternative of pricing their gas on the basis of the volume actually delivered to the pipeline which still contains the carbon dioxide provided that the Btu content of the gas is also measured at that time. In these circumstances gas consumers will not be paying for carbon dioxide because the Btu content will be considerably below the minimum 1,000 Btu content established as an area standard in this proceeding and the price will be reduced accordingly.

Under either alternative the pipelines' cost of processing actually incurred to remove the carbon dioxide should be deducted from the area base rate to determine the applicable ceiling price. If the producer prefers to price his gas on the basis of the volume remaining after the carbon dioxide is removed, the Btu content for purposes of the adjustment provided herein shall be measured on the basis of the volume of gas after such removal and the total amount to be paid for gas should also be computed on the volume of gas remaining after the carbon dioxide has been removed.

Recovery of Processing Costs by the Pipelines

In setting forth the procedures in Opinion No. 468 for determining the amount of the reductions from the base price to reflect processing costs to bring the gas up to our quality standards, we provided that we would accept agreements between the producer and the pipeline as to the extent of the processing costs involved. It has been suggested that the likelihood of reaching agreement in most cases has been impaired by an indication in the opinion that if a pipeline agreed with producers upon the amounts of processing costs it could not thereafter claim more as part of its cost of service. We did not intend such an arbitrary rule. We

recognize, of course, that no negotiated cost can be expected to be absolutely accurate, that costs may vary over the years, that legitimate processing costs may be incurred to bring the gas up to a quality standard higher than we are prescribing for rate adjustment purposes, that some processing facilities must incorporate reserve capacity for use in pipeline operations, and that there are other legitimate processing costs that may be in incurred by a pipeline not accounted for in the negotiated price.

We emphasize our desire to encourage agreement between the parties as to the proper amounts to be paid or deducted for quality adjustments. While we do not intend to permit the agreements between producers and pipelines to be used for the purpose of establishing arti-

ficially low processing costs, with the pipeline and ultimately the consumer making up the difference, we will approve all such agreements which reflect a good faith effort to approximate the processing costs involved, and accept for the pipelines' rate purposes the adjustments computed thereunder. In reaching such agreements the parties may utilize average processing costs where cost data for individual contracts are not readily available. No pipeline need fear that any such agreement will prejudice its claims to its legitimate costs not covered by the agreement.

New Gas-Well Gas From Committed Acreage

The producers contend that frequently there may prove to be extensive gas deposits at horizons below those already tapped by oil or gas wells. They strongly argue that the development of acreage now committed under old gas contracts may be inhibited if future discoveries of gas-well gas from such acreage do not command the higher ceiling for new gas-well gas. We believe this point deserves further consideration.

There is merit to the contention that the basis for classifying additional discoveries of gas-well gas from deeper reservoirs should not depend solely on whether there has been prior dedication but rather on whether such classification will encourage the directional search for gas. The issue is thus whether the new gas-well gas ceiling is needed in the public interest for gas from committed acreage. One factor to be considered is that lease acquisition costs have already been incurred in connec-

tion with committed acreage. Another relevant question is how much information as to the existence of gas at lower levels is provided by wells that have already been drilled.

278,709

On a full record, the producers may well be able to demonstrate that gas discovered in new reservoirs separate from existing reservoirs and at lower depths should command the new gas ceiling irrespective of prior dedications. On this record, however, the issue was not developed by the parties sufficiently to serve as a basis for departing from our past policy of applying the new gas price only to gas that has not yet been committed to the interstate market.

We believe the issue should be fully developed in the *Hugoton-Anadarko* case, AR64-1, and any change in policy will be applied prospectively to the Permian Basin.

Revenues v. Costs

A major argument presented in the several producer applications for rehearing is that, because of the quality adjustments (presumably even as we are modifying them herein), the Commission has not fixed area rates at a level high enough to produce overall revenues which would in the aggregate match producer "costs." The argument fails to take account of the fact that the cost of gas-well gas that served as a yardstick for establishing the area rate includes a twelve percent rate of return (amounting to about 5 cents per Mcf) which the Commission expressly indicated was set at this figure in part

(and in the case of flowing gas, where the problem of low-quality gas is more pronounced, in large part) in order to compensate for the risk of finding gas of less than pipeline quality.

The producer's "revenue deficiency" argument is also in error in assuming that the flowing gas costs 14.5 cents per Mcf, or that the Commission so found. The Commission used the cost of flowing gas-well gas as the basic yardstick for fixing the price of all flowing gas (for the reasons stated in Opinion No. 468, pp. 70-77). While the cost of residue gas cannot be found with the precision requisite to serve as a basis for fixing ceiling prices, the evidence in the record makes clear that with respect to casinghead gas and residue gas derived therefrom (which together make up by far the largest share of the Permian gas subject to quality adjustments)

the costs are substantially below the 14.5 cents per Mcf ceiling price. For one thing the price includes a 4.08 cents allowance for exploration and development expense even though such gas was largely found as a by-product of the search for oil. For another, there would be no reason to allow producers a 12 percent rate of return on their investment for processing residue gas since the investment in processing plants and equipment is subject to few of the special risks incurred by those who explore for and develop reserves of gas.

We do not mean to suggest that the E&D allowance and the profit which we have provided for flowing gas is not fully justified, but we believe it is relevant to point

out that these two items, which account for 9.0 cents of the 14.5 cents price for flowing gas, are based in part on justifications other than cost, and provide ample allowance for the risk that low-quality gas in the area may not command the full area price.

It is relevant also in any comparison of revenues and costs in the Permian Basin to consider the additional producer revenues under the *Spraberry* contracts which govern the sale of approximately 20 percent of the gas sold in the Permian Basin. Under these contracts the producers will receive, in addition to the ceiling price for residue gas, substantial payments for the liquids which the pipelines extract from the unprocessed gas. The record does not reveal the precise amount of such revenues but the contracts and billing statements on file with the Commission confirm that they are substantial.

The producers' comparison of revenues and costs also fails to reflect a substantial amount of revenue which we did not take into account in any way in computing the cost of old gas-well gas, and which we may have underestimated in determining the new gas-well gas price. We refer to the payments received by the sellers of gas-well gas for liquid hydrocarbons extracted from the gas by the pipelines. El Paso points out in its application for clarification that these liquid credits approximate on the average 0.6 cents to 0.8 cents per Mcf in the Permian Basin. This may be contrasted with the plant liquid credit of 0.2 cents based on nationwide statistics used in computing the cost of new gas-well gas and the absence of any such credit against costs in the flowing gas computation.

The precise amount of the plant liquid credit which El Paso states it pays to the producers is not verified by evidence in the record although the contracts for the sale of gas-well gas in the area reveal that such payments are generally made. In these circumstances we do not believe it appropriate to adjust the cost to reflect this undetermined amount of additional producer revenue. However, it is clear that this revenue, which is separate and apart from payments for excess Btu's in the gas after removal of liquids, tends to offset any reduction in aggregate revenues due to downward quality adjustments.

The application by the Major Producers refers to "the Commission's finding that jurisdictional revenues will equate to jurisdictional costs." The Commission made no such finding. Obviously the Commission cannot allow higher rates to offset "revenue deficiencies" resulting from producer contract prices below the area ceiling. The Major Producers' own petition states that the "revenue deficiencies" resulting from these contractural limitations amounts to 0.76 cents per Mcf. It would be contrary to all regulatory principles to permit prices in excess of an otherwise just and reasonable rate for certain purchases merely because other sales had been voluntarily made at below full cost as herein determined.

It is argued that because it is impossible to quantify exactly the extent of quality discounts there can be no basis for determining the validity of the Commission's rate of return determination either as a whole or to the

extent that it purports to reflect the risk of quality deficiency. The record does not leave us as much in the dark in this matter as the producers would have us believe. As Commissioner O'Connor stated in his concurring opinion, the record indicates that for gas-well gas under Opinion No. 468 "the reasonable amount of the average adjustment will be in a range of from 1.0 cents to 1.7 cents." With the changes we have here made with respect to quality standards, the average adjustments for gas-well gas will range from 0.7 cents to 1.5 cents, reduced by the additional revenue for plant liquids and the effect of the Btu adjustment.

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As to the flowing gas, the additional upward adjustment for gas with a Btu content of more than 1,050 Btu, coupled with the change in pressure standards substantially reduces the amount of downward adjustments. We have already noted the offsetting revenues to the producers from liquid credits and the fact that the cost of residue and casinghead (the bulk of the gas in the area) is substantially lower than the 14.5 cents price.

While it is true that neither the amount of the downward quality adjustments or the offsetting sources of additional revenue can be determined precisely, we are convinced that the record fully justifies the Commission's judgment that the ceiling prices we have fixed "provide a fair relationship between the aggregate price the consumer pays and the aggregate costs that the producers incur" in the Permian Basin.

Flowing Residue Gas-Cost and Price

It has been stated in the applications of several producer-respondents that the price of residue gas derived from casinghead gas should be fixed at a higher price because the record contains evidence which would establish this cost at a level above the 14.5 cents per Mcf based on gas-well gas costs. The record does not support this argument. On the contrary, while a precise cost computation of residue gas cannot be made with sufficient assurance of accuracy to serve as a basis for fixing prices the evidence demonstrates that the cost of residue gas is lower than the cost of flowing gas-well gas. The defects in the evidence which the producers cite were pointed out by the examiner. (Initial Decision, pages 103-107.) The staff in its exceptions agreed with the examiner's downward adjustment of its figures. Without passing on the merits of the evidence it certainly does not support a higher price for residue gas.

The Differing Base Rates in Texas and New Mexico

Some of the applicants appear to have misunderstood the nature of our determination in fixing base rates for Texas production inclusive of production taxes, while fixing base rates for New Mexico to which present New Mexico taxes may be added. At the present time taxes in New Mexico are not

uniform, and different sales of natural gas within that state may be subject to quite different taxes. In the State of Texas, on the other hand, a production tax of 7 percent

applies uniformly to all sales. It is possible, therefore, to compute base rates including taxes which would be applicable to all Permian Basin production within the State of Texas. Since this is not possible with respect to New Mexico production, a different formula is used. The net result, however, is precisely the same for the two states — in each case the present taxes are included in computing the total prices which may be charged. This is not a determination that any and all taxes which the State of New Mexico may choose to impose in the future may be added to New Mexico base prices.

In its petition for rehearing El Paso requests the Commission to clarify whether in computing the applicable state and local production taxes for New Mexico there should be included the New Mexico Oil and Gas Ad Valorem Production Tax. The records of this proceeding show that such a tax is a property tax, not a production tax, and as such was included in our computation of the cost of finding and producing gas. Accordingly such tax shall not be included in computing the applicable New Mexico production taxes.

Refund Below the Last Clean Rate

First raised by Skelly, and repeated in other applications, is the contention that "the Commission's refund order exceeds its refund authority under Section 4(e) which is limited to the increased increment in the rate between the time the suspended increased rate is made effective and the date of the Commission's final order in the suspension proceeding." With this contention we

need not deal at this time, since no such situation has been presented as resulting from our order herein. It will be time enough to deal with this issue when and if it is established that any refunds below the last clean rate are required.

Classification of Gas on Basis of Contract Date

It has also been contended that contracts should not be classified as contracts for new or old gas by reason of the date of the contract, but rather on the basis of the date the gas was first committed to interstate commerce, assuming commitment occurred at a later date. We have chosen the

date set forth in the contract because that date is precise, definite and certain, whereas the date of commitment of gas to interstate commerce is less easy of ascertainment. We therefore do not believe any change in our decision on this issue is warranted.

Refunds — Pipeline Verification

We agree with El Paso that a condition should be attached to the refund requirement that it should be required that the purchaser verify the refund calculations, and the order accompanying this opinion will so provide.

Method of Rate Determination

Some confusion apparently exists with respect to the method of determining the proper price under a given contract. If a producer has a contract calling for a stated

price with specified increases for additional Btu content or specified deductions for certain quality deficiencies, the contract price is to be computed as though no price regulation existed. As a second step it will be necessary to compute the applicable area rate for the gas sold under the contract, without regard to the contract price provisions. The area rate will be the applicable base rate plus or minus the quality adjustments allowed or required by our decision and order. The proper rate to be charged and collected under the contract will be the contract price if it does not exceed the applicable area rate. If it exceeds the applicable area rate the latter will apply.[3]

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Rates Involved in Application of Order to Unconsolidated Section 4(e) Proceedings

In the Addendum to its Supplemental Application for Rehearing Shell inquiries whether ordering paragraph (E) of Opinion No. 468 applies to pending Section 4(e) proceedings not consolidated herein but which are subject to the Order to Show Cause issued in conjunction with Opinion No. 468. Paragraph (E) as previously

[3] For example, if a contract for new gas-well gas provides for a price of 16.0 cents with a proportionate upward Btu adjustment for Btu's in excess of 1,000 per Mcf, and the gas contains 1,030 Btu's per Mcf, the contract price would be 16.48 cents, assuming there are no other adjustments called for under the contract. The applicable area rate in Texas would be 16.5 cents per Mcf — the area base price with no upward or downward Btu adjustment, since 1,030 Btu's is in the range between 1,000 and 1,050. The proper rate chargeable under the contract would be 16.48 cents. If the same contract were for old gas-well gas produced in Texas the proper rate would be 14.5 cents since the applicable area rate would be lower than the contract rate.

modified requires that a supplement be filed by November 15, 1965, to each filed rate schedule in excess of the area base rate reflecting reductions to conform the filed rate to the area base rate. Pursuant to section 5(a) of the Act we have ordered all rate schedules of respondents which are in excess of area base rates to be reduced in conformity with paragraph (E). The fact that a respondent's rate schedule may be subject to an unconsolidated section 4(e) proceeding for a past period does not relieve respondent of filing a supplement in conformity with paragraph (E). The only remaining function of the unconsolidated section 4(e) proceeding is with respect to refunds for past periods to which the section 5(a) proceedings do not apply.

Requests for Stay of Order

A number of the producers have requested a stay of all or some of the ordering paragraphs of Opinion No. 468, until after completion of contemplated judicial review proceedings. Section 19(c) of the Natural Gas Act makes it clear a stay is not warranted for the sole reason that judicial review is to be sought. At a minimum, parties seeking a stay should demonstrate that any injuries they suffer, absent a stay, would be irreparable and would outweigh the irreparable injury to the public from granting the stay. See, *e.g.*, *Virginia Petroleum Jobbers Association* v. *F.P.C.*, 259 F. 2d 921 (CADC); *Associated Securities Corp.* v. *S.E.C.*, 283 F. 2d 773 (CA10); *Tennessee Gas Transmission Co.* v. *F.P.C.*, 283 F. 2d 729 (CA5).

The producers failed to make such a showing. If the order were set aside, the producers would not be precluded from recovering the difference between the rates collected and the rate which the producers should have been permitted to collect.[4] The Commission, in the event of judicial reversal, would have adequate authority, including power to fix future rates, to take any necessary corrective action to protect not only the producers but also the pipeline purchasers.

In any event, even a showing of irreparable injury would normally not be sufficient in itself to warrant a stay of a rate reduction or moratorium order when it is outweighed by the detriment to the public. As the courts have held (*e.g., Virginia Jobbers Association* v. *F.P.C.*, 259 F.2d 921 (CADC)), the effect of a stay on other interested parties and the public interest are of at least equal significance to the impact on private parties of its denial. In this case, grant of stay would mean the continued collection of rates which we have found, after careful consideration, to be excessive. Even if all such amounts were subject to refund requirements, it is well recognized that the protection afforded through the re-

[4] *Hunt Oil Company, et al.*, in their motion for stay, recognize this in their alternative suggestion that some of the ordering paragraphs, including paragraph (H), imposing the rate increase moratorium, be made effective "upon the express condition that to the extent that they are not judicially affirmed, if judicial review is sought thereon, they will be null and void *ab initio* and appropriate redress procedures would be adopted by the Commission to rectify any detriment which the Movants might suffer as a result of compliance with the Ordering Paragraphs which are subsequently reversed or modified."

fund procedure will not give full protection to the ultimate consumers. *F.P.C.* v. *Tennessee Gas Transmission Co.*, 371 U.S. 145, 154-155; *F.P.C.* v. *Hunt*, 376 U.S. 515, 524-525. We need not repeat the discussion set forth in Opinion No. 468 of why the moratorium of rate increases above the ceiling prices is essential. A stay of the moratorium would mean its elimination. As we observed

"Without a moratorium, the conclusion of one area proceeding would only signal the beginning of the next, and just and reasonable rates for consumers would always be one area proceeding away." [Opinion No. 468, p. 108]

Delay in giving effect to the ordered rate reduction in this case will be doubly injurious to the California consumer to whom most of the Permian gas is delivered, because it is our understanding that the Southern California distributing companies which purchase gas from El Paso and Transwestern also purchase substantial quantities of gas from California producers under long-term contracts in which the price is geared to the weighted average California border price for wholesale gas and is adjusted to reflect the border price in effect January 1 of each year. See *Re Pacific Lighting Gas Supply Co.*, 44 PUR 3d 177, 184 (Calif. P.U.C., 1962). Thus, a stay of the ordered rate reductions and the consequent delay in pipeline rate reductions would result in unrecoverable losses to the California distributing companies and presumably their customers. The Court of Appeals for the Fifth Circuit expressly took this factor into account in denying El Paso's request to stay the rate reductions ordered by us

in October 1962, *El Paso Natural Gas Co.* v. *F.P.C.*, CA5, No. 20180, December 21, 1962 (unreported).

Several producers also base their request in part on the assertion that, absent a stay, complex problems relating to royalty payments and state tax payments will have been created. It is not shown that such problems would cause irreparable harm. Moreover, as applicants recognize, any stay that might be issued should be on condition that all rates required to be reduced under Opinion No. 468 be collected subject to refund obligations at least for the period starting September 1, 1965, the effective date of Opinion No. 468. In view of this, it would not appear that an immediate rate reduction, with the opportunity for recoupment of undercharges in the event of judicial modification or reversal of our order, would create more complex problems with respect to royalty and tax payments than would exist with respect to the collection of rates subject to refund, pursuant to either a stay condition or existing requirements.

In these circumstances, the requested stay of the ordered rate reductions and the moratorium on increased rates would be totally unwarranted.

Even though the Opinion No. 468 does not require refunds to be made for rates collected prior to September 1, 1965, until further Commission action is taken, it is appropriate to indicate now that we will not take such further action until at least after the decision by the Court of Appeals which reviews Opinion No. 468. We

recognize that with respect to rates collected subject to refund for as much as 8 years prior to Opinion No. 468, the various inadequacies of the refund procedure as they relate to this case cannot be avoided even by immediate refunds. The prompt effectuation of just and reasonable rates for the future is of primary importance and the deferral of refunds due will provide additional insurance that our order in this respect cannot result in irreparable injury to the producers. Postponement of further Commission action requiring refunds is therefore deemed appropriate.

Other Matters

Certain producers presented contentions which related to their individual circumstances. Without suggesting that these contentions stated adequate grounds for special relief under Opinion No. 468 it is clear that they do not state any basis for modification of our area rate order which is of general application.

Numerous other arguments were advanced by producers in their application for rehearing but they have all been adequately disposed of by the full discussions supporting our findings and order in Opinion No. 468. The applications, therefore, should be denied except insofar as we have modified our order as provided herein.

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The Commission further finds:

(1) The quality standards and adjustments to the base area rates set forth in Opinion No. 468 and accompanying order should be modified as provided in the ordering provisions hereinafter set forth.

(2) The applications for rehearing and accompanying motions set forth no new facts or principles of law which either were not fully considered by the Commission when it adopted Opinion No. 468 and its accompanying order, or which now being considered warrant any change in, vacation or modification of such order, except as set forth herein.

(3) Good cause has not been shown for reopening this proceeding for receipt of additional evidence.

The Commission orders:

(A) Each and every reference in Opinion No. 468 or its accompanying order, or in Opinion No. 468-A or this accompanying order, to Texas Railroad District No. 8 shall be considered to include both the present Texas Railroad Districts 8 and 8-A.

(B) Paragraph (B) of the order issued together with Opinion No. 468 shall be amended to read as follows:

"(B) *Quality Standards and Adjustments to the Base Area Rates*

(1) The base area rates fixed in ordering paragraph (A) herein shall be adjusted for any deviations from the standards for pipeline quality gas in Texas Railroad District Nos. 7-c and 8, and in the New Mexico counties of Lea, Eddy and Chaves, which are hereby established as follows:

a. *Carbon Dioxide:* Pipeline quality gas shall contain not more than 3 percent carbon dioxide by volume.

b. *Hydrogen Sulphide:* Pipeline quality gas shall contain not more than 10 grains of hydrogen sulphide per Mcf of natural gas at 14.73 psia and 60° F.

c. *Total Sulphur:* Pipeline quality gas shall contain not more than 200 grains of total sulphur per Mcf of natural gas at 14.73 psia and 60° F.

d. *H_2O:* Pipeline quality gas shall contain not more than .009 pound of H_2O per Mcf of natural gas at 14.73 psia.

e. *Other Impurities:* Pipeline quality gas shall contain no oxygen, dirt, dust, gum, or other impurity in sufficient amounts to require the buyer to incur processing costs to eliminate such impurities in order for the gas to meet either customary commercial standards or the customary requirements of any of the interstate pipelines in the area.

f. *Pressure:* Pipeline quality gas shall be delivered at a pressure of not less than 500 pounds per square inch gauge.

g. *Btu Adjustment:* The maximum standard will be 1,050 Btu's per cubic foot at 14.73 psia and 60° F. and the minimum standard will be 1,000 Btu's per cubic foot at 14.73 psia and 60° F. Upward and downward adjustments of the base area rates will be on a proportional basis as specified at pages 99-100 of Opinion No. 468 if the Btu content exceeds the maximum standard or is below the minimum standard.

(2) When a purchaser buys gas which deviates from the quality standards established in subparagraph (1) above, the base area rate fixed in ordering paragraph (A) shall be adjusted for any deviations from such standards as follows:

a. The applicable base area rate shall be adjusted downward by the net cost, actually in-

curred prior to ultimate consumption, of processing the gas to bring it up to standard.

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(i) If the processing is performed by the purchaser, a reasonable return upon the net investment should be included as part of the processing cost incurred in bringing the gas up to pipeline quality.

(ii) If such processing reduces the volume of the gas, the purchaser shall pay for only the volume remaining after processing.

(iii) If the seller is ready and able to deliver natural gas into buyer's facilities without further compression, at pressures higher than the pressure at which the buyers' facilities available at the point of delivery can accept such gas, any downward adjustment for the cost of compression shall be limited to the cost of such compression as is incurred to raise the pressure of the gas from the pressure at which the seller is ready and able to deliver it up to the pressure standard of 500 psig.

b. The applicable base area rate shall be adjusted downward or upward by the amount of any applicable Btu adjustment.

c. In the case of delivery by seller of gas containing carbon dioxide in excess of the standards herein permitted, notwithstanding anything to the contrary in Paragraph (2)(ii) of this order, the producers shall have the alternative of receiving payment for the total volume of gas delivered, including the carbon dioxide,

provided that the Btu content of the gas is measured before removal of the carbon dioxide for the purposes of the Btu adjustments specified in this order, or receiving payment for the volumes exclusive of the carbon dioxide with the Btu content measured by the volumes of gas only."

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(C) Ordering paragraph (F)(1) of the order accompanying Opinion No. 468 is hereby amended by deleting "for new gas-well gas" from line 17 of said ordering paragraph.

(D) Ordering paragraph (I) of the order accompanying Opinion No. 468, designated "Refund Reports", is hereby amended by inserting after the first sentence of said ordering paragraph, the following:

"Within 10 days from the filing of the refund report the buyer shall file its written concurrence or disagreement with such report."

(E) Ordering paragraph (J) of the order accompanying Opinion No. 468 is hereby amended by changing "(E)" to "(I)" in line 2 thereof.

(F) Appendix A, Part III to Opinion No. 468 and its accompanying order is hereby amended as follows:

(a) Page 17, with reference to "Robertson, French, M. & J. P. Bryan (formerly G. Stratton, Jr. (Operator), *et al.*,)" insert a "**" after Docket No. G-16535.

(b) Page 21, delete "Sun Oil Company" and the related Docket No. "RI60-123."

(c) Page 21, delete "Sun Oil Company (Operator), *et al.*" and related Docket No. "RI60-124."

(d) Page 7, with reference to "Aikman, Claude E.", delete Docket No. "G-18466."

(e) Page 21, with reference to "Superior Oil Company, The" delete Docket Nos. "G-18771" and "G-20075."

(G) Appendix D to Opinion No. 468 and its accompanying order is amended to conform to the form of Appendix D to Opinion No. 468-A and this accompanying order.

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(H) The applications for rehearing of Opinion No. 468 and accompanying order, and the motion of Hunt Oil Company, *et al.*, to reopen this proceeding for receipt of additional evidence, are hereby denied.

(I) The motions for stay of Opinion No. 468 and accompanying order, except to the extent granted by the Order Granting Time Extension issued September 28, 1965, in this proceeding, are hereby denied.

By the Commission. Commissioner O'Connor concurring filed a separate statement appended hereto.

(SEAL)

Gordon M. Grant,
Acting Secretary.

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ket Nos. AR61-1, et al.

APPENDIX D
(As amended by Opinion No. 468-A)

RATE SCHEDULE-QUALITY STATEMENT

1. APPLICABLE SECTION 4(e) DOCKET NO(S). (If any) (Use space below if needed)

PRODUCER NAME

3. RATE SCHEDULE NO.

TYPE OF GAS (Check one)

- ☐ NEW GAS-WELL GAS
- ☐ RESIDUE GAS DERIVED FROM NEW GAS-WELL GAS
- ☐ RESIDUE GAS NOT DERIVED FROM NEW GAS-WELL GAS
- D. ☐ OLD GAS-WELL GAS
- E. ☐ CASINGHEAD GAS
- F. ☐ MIXED GAS (Give proportion of types A and B) _____

LACE OF PRODUCTION (Give State, County, Field and Municipality)

UALITY OF GAS	PRODUCER'S STATEMENT OF QUALITY AND TREATING COSTS		BUYER'S STATEMENT OF QUALITY AND TREATING COSTS (If same as producer, indicate by check mark)	
	CONTENT OR PRESSURE	COST PER MCF OF TREATING GAS TO PIPELINE STANDARDS	CONTENT OR PRESSURE	COST PER MCF OF TREATING GAS TO PIPELINE STANDARDS
HYDROGEN SULPHIDE CONTENT (In grains per Mcf)..				
TOTAL SULPHUR CONTENT (In grains per Mcf).....				
CO_2 CONTENT (Percentage of volume sold).....				
H_2O CONTENT (In pounds per Mcf).....				
CONTENT OF OTHER IMPURITIES (Indicate whether above or below customary commercial and pipeline standards).....				
ACTUAL DELIVERY PRESSURE (Pounds per square inch)				
TOTAL				
BTU CONTENT PER MCF				

PPLICABLE AREA CEILING RATE _____ cents per Mcf

8. BTU PRICE ADJUSTMENT (State whether plus or minus) _____ cents per Mcf

PPLICABLE RATE (Ceiling rate less treating costs ith Btu adjustments if any) _____ cents per Mcf

10. RATE HERE ESTABLISHED (Not above applicable ceiling rate as adjusted) _____ cents per Mcf

SAMPLE COPY

OTHING HEREIN SHALL PREVENT THE SELLER FROM FILING FOR ANY INCREASED RATE PERMITTED BOTH BY THE CONTRACT IN THE ABSENCE OF THIS STATEMENT) AND BY APPLICABLE ORDER OF THE FEDERAL POWER COMMISSION.

12. SIGNATURE OF SELLER, AGENT OR OPERATOR

ATE OF STATEMENT

13. SIGNATURE OF BUYER

E:
TERMS HEREIN ARE THOSE USED IN THE OPINION OF THE FEDERAL POWER COMMISSION IN PERMIAN BASIN AREA RATE CEEDING, AR61-1. NEW GAS-WELL GAS IS NATURAL GAS DERIVED FROM GAS WELLS MOVING UNDER CONTRACTS DATED ON AFTER JANUARY 1, 1961. THE BURDEN IS UPON A PRODUCER TO ESTABLISH THAT PARTICULAR GAS IS NEW GAS-WELL OR RESIDUE GAS DERIVED THEREFROM, AND ALSO TO ESTABLISH THE PERCENTAGE OF SUCH GAS PRESENT IN A SALE IXED GAS.

278,725

Area Rate Proceeding	*Docket Nos.*
Claude E. Aikman, *et al.*	AR61-1
North Central Oil Corporation (Operator), *et al.*	G-18466, *et al.* CI60-435, *et al.*

O'CONNOR, Commissioner, *concurring:*

Though concurring in the result reached by the majority, I do not rely upon their reasons, and I specifically re-emphasize my position in regards to the 50-Btu gap. It is apparent from the petitions for rehearing of our Opinion No. 468 that a strong possibility exists producers will not be in a position to realize aggregate revenues which reasonably approximate their aggregate costs. Since the specific problem is that of rate design for quality deviations, the impact of which cannot be determined on the record before us, rehearing is properly denied; nevertheless, once the impact is made clear by the quality adjustment determinations, it is entirely likely that rate revisions will be required.

It must be emphasized that, while the specific problem is that of proper quality adjustments, the impact of the overall adjustments can be burdensome to the extent the entire regulatory method is vulnerable. Clearly the impact of a regulatory rate must be considered, *F.P.C.* v. *Hope Natural Gas Co.*, 320 U.S. 591, 602 (1944), and, in the event the order does not permit the regulated enterprise an opportunity to recover its costs, then it must fall, *Natural Gas Pipeline Co.* v. *F.P.C.*, 315 U.S. 575, 590 (1942). This rule is applicable as well to group cost

regulation. Cf. *Bowles* v. *Willingham*, 321 U.S. 503, 517-519 (1943). Inherent in the majority opinion is an acknowledgment of this state of the law, and presumably a clear showing of an adverse impact will command revision. It is my position that further revisions will commend themselves to us once the quality impact is clarified.

The record does not permit a meaningful determination of the impact. As discussed in my separate opinion, the probable range will be 1.0 to 1.7 cents. This range is based upon various allegations of a general nature at the hearing and upon the ascertainable costs of processing out the deficiencies. The modified standard for pressure, and the general application of the upward Btu adjustment further alleviates the downward impact. In my opinion the upward adjustment from 1000 Btu's would represent a proper accommodation of costs to quality, and it should be adopted as a proper measure of quality standards. This is all the more compelling in light of the comprehensive study by Shell Oil Company in their Supplemental Petition for Rehearing. According to their figures the maximum

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downward impact could be in a range from 1.86 to 2.27 cents. Adjusted for the revised quality standards adopted today, this range could be 1.6 to 2.0 cents. If the quality impact is of these proportions modification may be required.

I reject the broad generalities relied upon by the majority for rejecting the cost-revenue argument. Their

broad conclusion that producers realize sufficient revenues in any event must be rejected. Federal regulation extends only to natural gas, and producers cannot be compelled to offset a deficit from the commodity with revenues from non-jurisdictional petroleum sales. Cf. *Baltimore & Ohio R.R.* v. *U.S.*, 345 U.S. 143 (1953). It is my position that where the public demands the creation of fettered enclaves of business enterprise, fundamental fairness requires that this same public shoulder the financial requirements of that enterprise. Further contradicting the majority position, it is far from clear that residue costs are less than gas-well costs. At the hearing and in argument before the Examiner, Staff initially took the position that residue costs were probably higher. To bury the quality impact in our rate of return determination is to overlook the basis for the 12 per cent allowance: comparable return on equity of 10-12 per cent by the far less risky operations of transmission companies. Finally, as regards self-imposed revenue deficiencies, many of the lower contracts apparently reflect quality deductions so that revenues realized under those contracts may remain below cost even under the quality standards we have prescribed.

The only proper basis for rejecting the quality impact argument is that the impact cannot be established. The actual conditions of delivery cannot be accurately determined from the record. Furthermore, the quality standards we prescribe may result in less onerous adjustments than the contracts require. We are thus left in the position of being unable to determine the impact. It is my

position that with the elimination of the Btu gap, any present doubts would disappear, and it is probable that no further adjustments would be required.

/s/ L. J. O'Connor, Jr.
L. J. O'Connor, Jr.
Commissioner

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UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Before Commissioners: Joseph C. Swidler, Chairman;
Lawrence J. O'Connor, Jr.;
Charles R. Ross; and
David S. Black

	Docket Nos.
Area Rate Proceeding	AR61-1 *et al.*
North Central Oil Corporation (Operator) *et al.*	CI60-435
Socony Mobil Oil Company, Inc.	CI61-34
Robert T. Brown (Operator) *et al.*	CI61-733
Texaco Inc.	

ORDER DENYING REHEARING AND MODIFYING ORDER WITH RESPECT TO ISSUING CERTIFICATES

(Issued October 4, 1965)

On August 5, 1965, this Commission issued its order in this proceeding granting certificates of public convenience and necessity to four producers upon stated conditions, among which were included price conditions to the applicable area rates as established by Opinion No. 468 and accompanying order issued the same day. Applications for rehearing of Opinion No. 468 and the Order Issuing Certificates were filed by *North Central Oil Corporation, (Operator) et al.*, (North Central) and *Texaco Inc.*, two of the producers to whom certificates

were issued, and the applications of others for rehearing of Opinion No. 468 were also addressed to the Order Issuing Certificates. By Opinion No. 468-A and accompanying order issued this day we have denied the applications for rehearing of Opinion No. 468 and its accompanying order while modifying that opinion and order in certain respects.

North Central, in its application for rehearing states that its original contract was dated in 1960 but that the Supplemental Gas Purchase Agreement which was the subject of the same filing was dated March 9, 1961. It is North Central's contention that the gas dedicated under the supplemental agreement of March 9, 1961, is entitled to the new

gas-well gas price of 16.5 cents per Mcf, since the supplemental agreement was dated after January 1, 1961, the dividing date between old and new gas-well gas. North Central argues that it would be pure formalism to require a new and separate contract instead of a supplemental agreement in order to allow a producer to charge and collect the applicable area rate for new gas-well gas. We agree. Accordingly, our Order Issuing Certificates of August 5, 1965, will be modified to provide that the price condition in the certificate to be issued to North Central allow a price of 16.5 cents per Mcf for natural gas moving under the supplemental agreement of March 9, 1961.

One further matter requires clarification. The applications of *Socony Mobil Oil Company, Inc.*, (Docket

No. CI61-34) and *Texaco Inc.* (Docket No. CI61-879) involve Spraberry contracts discussed in detail in Opinion No. 468. Consistent with that discussion and the arguments advanced in the applications for rehearing we believe the applicable area rate should be applied to the residue volumes, with no deductions therefrom if the residue volumes meet the pipeline quality standards set forth in Opinion No. 468, as modified by Opinion No. 468-A. The consumers will thus pay no more for gas under the Spraberry contracts than any other gas of similar quality. As we indicated in Opinion No. 468, if the pipelines' processing costs exceed the liquid revenues the pipeline can petition for relief in the form of "an appropriate reduction in the price the pipeline pays for such residue gas." Our previous discussion in the Order Issuing Certificates herein is so modified. Any deductions required by contract must, of course, be utilized in determining the contract rate.

The applications for rehearing of the Order Issuing Certificates set forth no other facts or arguments which differ from those which were advanced and fully considered prior to our determinations of the issues in Opinion No. 468 and accompanying order and our determinations of the issues in the original Order Issuing Certificates. Accordingly, the applications for rehearing will be modified as previously stated.

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The Commission finds:

(1) The natural gas to be sold by *North Central Oil Corporation, (Operator) et al.*, under the Supplemental

Gas Purchase Agreement of March 9, 1961, is new gas-well gas as defined in Opinion No. 468 issued August 5, 1965.

(2) Except as stated herein, the arguments and assignments of error presented by the applications for rehearing warrant no change or modification in the Order Issuing Certificates issued August 5, 1965.

The Commission orders:

(A) Paragraph E of the prior Order Issuing Certificates issued August 5, 1965, is amended to read as follows: "The certificate granted to *North Central Oil Corporation (Operator) et al.*, is conditioned upon a total initial price including tax reimbursement of 14.5 cents per Mcf at 14.65 psia for all gas other than that sold pursuant to the Supplemental Gas Purchase Agreement dated March 9, 1961, and upon a total initial price including tax reimbursement of 16.5 cents per Mcf at 14.65 psia for all gas sold pursuant to the Supplemental Gas Purchase Agreement. On or before November 1, 1965, *North Central Oil Corporation, (Operator) et al.*, shall file a supplement or supplements to its presently filed rate schedule reflecting the conditioned prices as the initial prices in lieu of the initial price provided in the rate schedule.

(B) The applications for rehearing of the Order Issuing Certificates of August 5, 1965, are hereby denied.

By the Commission.

(SEAL)

Gordon M. Grant,
Acting Secretary.

UNITED STATES COURT OF APPEALS
TENTH CIRCUIT

Nos. 8385, 8409, 8440, 8455, 8458, 8460, 8479, 8482, 8487, 8488, 8489, 8490, 8493, 8494, 8495, 8496, 8497, 8501, 8505, 8510, 8511, 8517, 8519, 8521, 8528, 8529, 8534, 8540, 8541, 8542, 8588 and 8589

JANUARY TERM, 1967

SKELLY OIL COMPANY; PHILLIPS PETROLEUM COMPANY; WARREN PETROLEUM CORPORATION; MOBIL OIL CORPORATION (formerly Socony Mobil Oil Company, Inc.); PAN AMERICAN PETROLEUM CORPORATION; NORTHERN NATURAL GAS PRODUCING COMPANY; STANDARD OIL COMPANY OF TEXAS, a Division of Chevron Oil Company; TEXACO INC.; HUNT OIL COMPANY jointly with H. L. Hunt, Lamar Hunt, N. B. Hunt, W. H. Hunt, Secure Trusts, Caroline and Loyd B. Sands, Caroline Hunt Trust Estate, Lyda Hunt-Caroline Trusts, Lyda Hunt-Bunker Trusts, Lyda Hunt-Lamar Trusts, Lyda Hunt-Herbert Trusts, Lyda Hunt-Margaret Trusts (formerly Estate of Lyda Bunker Hunt, Deceased), Hunt Industries (formerly Estate of Lyda Bunker Hunt, Deceased), and Placid Oil Company; HUMBLE OIL & REFINING COMPANY; SHELL OIL COMPANY; THE ATLANTIC RICHFIELD COMPANY (formerly The Atlantic Refining Company) jointly with Dorchester Gas Producing Company, Southland Royalty Company, and Westates

FILED
United States Court of Appeals
Tenth Circuit

JAN 20 1967

William L. Whittaker
Clerk

Petroleum Company; CONTINENTAL OIL COMPANY jointly with Sunray DX Oil Company, Sinclair Oil & Gas Company, Cabot Corporation, Sohio Petroleum Company, Joseph E. Seagram & Sons, Inc., Joseph E. Seagram & Sons d/b/a Texas Pacific Oil Company, Gulf Oil Corporation, Murphy Oil Corporation, The Nueces Company, Samedan Oil Corporation, Cities Service Oil Company (formerly Cities Service Petroleum Corporation), Cities Service Production Company (now merged with Cities Service Oil Company), Columbian Fuel Corporation, Amerada Petroleum Corporation, Union Oil Company of California and as successor to The Pure Oil Company, Tidewater Oil Company, Reef Corporation, and William A. & Edward R. Hudson, Joint Operators; MARATHON OIL COMPANY; SUN OIL COMPANY; INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA; THE BRITISH-AMERICAN OIL PRODUCING COMPANY; UNION TEXAS PETROLEUM, a Division of Allied Chemical Corporation; MIDHURST OIL CORPORATION; THE SUPERIOR OIL COMPANY; PERRY R. BASS jointly with Panther City Investment Co., Bass Bros. Enterprises, Inc., Perry R. Bass, Incorporated, and Richardson Oils, Inc.; COLUMBIAN CARBON COMPANY jointly with Coltexo Corporation; THE STATE OF TEXAS; BIG CHIEF DRILLING COMPANY jointly with King-Stevenson Oil Company, Inc., and Service Drilling Company; TEXAS INDEPENDENT PRODUCERS AND ROYALTY OWNERS ASSOCIATION jointly with West Central Texas

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Tenth Circuit

JAN 20 1967

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Oil and Gas Association; STATE OF NEW MEXICO; GULF OIL CORPORATION; and J. C. BARNES, *et al.*,

Petitioners,

v.

FEDERAL POWER COMMISSION,

Respondent,

STATE OF CALIFORNIA jointly with Public Utilities Commission of the State of California; CITY OF LOS ANGELES; CITY OF SAN DIEGO; CITY AND COUNTY OF SAN FRANCISCO; PACIFIC GAS AND ELECTRIC COMPANY; PACIFIC LIGHTING SERVICE AND SUPPLY COMPANY (formerly Pacific Lighting Gas Supply Company) jointly with Southern California Gas Company and Southern Counties Gas Company of California; and SAN DIEGO GAS AND ELECTRIC COMPANY,

Intervenors.

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Tenth Circuit

JAN 20 1967

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Before LEWIS, BREITENSTEIN and HILL, *Circuit Judges.*

BREITENSTEIN, Circuit Judge.

The first area rate decision of the Federal Power Commission is before us for review. It relates to prices for jurisdictional sales of natural gas produced in the Permian Basin, a famous petroleum area where oil and gas are found in hundreds of reservoirs and thousands of wells. The states of Texas and New Mexico, the nation's oil and gas industry, and several related associations attack the decision. The State of California, the cities of San Francisco, Los Angeles, and San Diego, various local distributors, and an organization of such distributors supported. The rejection of the individual company cost-of-service approach to the regulation of independent producers and the adoption of the area rate method raise many novel issues which have been extensively and ably argued. We hold that neither the United States Constitution nor the Natural Gas Act bars the regulation of natural-gas prices on an area basis; that the Commission did not abuse its discretion in adopting the area method; and that the cases must be remanded because the actions of the Commission do not comply with the end result test established in Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 602-603, and other decisions.

The petitions for review, all brought under § 19(b) of the Natural Gas Act,[1] attack Opinions Nos. 468 and 468-A of the Commission fixing just and reasonable rates

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[1] 15 U.S.C. §§ 717-717w.

under §§ 4 and 5 of the Act for natural gas produced in the Permian Basin and sold to interstate pipeline companies.

1. *Background.*

The Permian Basin, as defined by the Commission, includes Texas Railroad Commission Districts Nos. 7-C, 8, and 8-A and the New Mexico counties of Chaves, Eddy, and Lea. Nationally, it accounts for about 11% of all the gas sold in interstate commerce. The Commission joined 336 producers as respondents in the consolidated proceedings. Sales by them are made to three interstate pipelines, none of which appear here.[2] About 85% of the Permian gas moving interstate goes to California.

Nearly two-thirds of the Permian gas production comes from oil-well gas, that is, gas produced in conjunction with oil. Because of impurities much of the gas must be processed before introduction to an interstate pipeline. Until El Paso began its purchases, Permian oil-well gas was generally vented or flared because of the lack of a market.

The natural-gas industry has three main parts, the producers, the interstate pipelines, and the distributors. The last are under state or local regulation exclusively. The Commission began federal regulation of the interstate pipelines after the passage of the Natural Gas Act

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[2] El Paso Natural Gas Company began buying Permian gas in 1945, Northern Natural Gas Company through a predecessor in 1954, and Transwestern Pipeline Company in 1958. In 1961, El Paso purchased 73% of the Permian gas moving in interstate commerce, Northern 18%, and Transwestern 9%.

of 1938. It did not attempt to regulate independent producers[3] until the 1954 decision of the Supreme Court in Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672, (First Phillips) which held that the Act applied to them.

Section 7 of the Act forbids the sale of natural gas subject to Commission jurisdiction without a certificate of public convenience and necessity granted after notice and hearing. Temporary certificates, issued without notice and hearing, are authorized. Our recent decision in Sunray DX Oil Company v. Federal Power Commission, 10 Cir., ... F.2d ....., discusses § 7 procedures and problems. These are not present here because the § 7 applications considered in the consolidated proceedings before the Commission were disposed of in a separate order.

Section 4 requires that all rates shall be just, reasonable, and nondiscriminatory. No change shall be made in a rate without 30 days' notice. When a schedule containing a changed rate is filed, the Commission on its own initiative or on complaint may suspend the rate and set the matter for hearing. The suspension may be for not longer than five months. If no decision is reached within that period, the increased rate becomes effective but the Commission may require a bond conditioned upon the refund of that portion of the increased rate found not to be justified. The instant proceedings involve a number of increased rate filings which were suspended under

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[3] The word "independent" is used to describe a producer which does not transmit gas interstate either by its own operations or those of an affiliate. Some of the interstate pipelines produce a share of their own gas and sell gas to other pipelines.

§ 4 and which were disposed of by Opinions Nos. 468 and 468-A.

Section 5 provides that whenever the Commission, after hearing had on its own motion or on complaint, finds that a rate is "unjust, unreasonable, unduly discriminatory, or preferential" it shall determine "the just and reasonable rate." In the proceedings at bar the Commission pursuant to § 5 established "the future rates for jurisdictional sales of gas by producers in the area."

After the First Phillips decision the Commission received thousands of certificate applications from producers. The situation was complicated by the need of pipelines for a committed source of supply sufficient to justify financing. To obtain such supply long-term contracts, commonly for 20 years, were made with the producers. They in turn, because they could not file unilaterally for an increased rate contrary to contract and because they desired protection against the unforeseeable economic conditions of the future, insisted on escalation clauses of various types.[4] A general price rise occurred. As the escalation provisions became operative the producers filed under § 4 for increased rates and the Commission suspended many of them. Section 7 applications were under contracts calling for rates comparable to those which the Commission had suspended. This trend was ended by the 1959 decision in Atlantic Refining Co. v. Public Service Commission of New York, 360 U.S. 378, (CATCO) which directed the Commission in certificate cases to keep initial prices in line.

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[4] See Pan American Petroleum Corporation v. Federal Power Commission, 10 Cir., 352 F.2d 241, 243.

After the remand in First Phillips, the Commission proceeded with the consideration of just and reasonable rates required by §§ 4 and 5 on the individual company cost-of-service basis which it had long applied in the regulation of electric power companies and interstate pipelines. The first case to reach the decisional stage was that relating to Phillips. On September 28, 1960, the Commission entered Opinion No. 338[5] in which it held that the regulation of independent producers under the Act could be accomplished more appropriately by the establishment of area rates than by the establishment of producer rates on individual cost-of-service findings. Contemporaneously with this Phillips decision, the Commission promulgated its Statement of General Policy No. 61-1[6] which established 23 rate areas and, with unimportant exceptions, announced maximum rates for each area. Two price standards were set, one for initial prices in new contracts and one for escalated prices in existing contracts. For the Permian Basin area the prices were 16 cents and 11 cents respectively.

Opinion No. 338 was affirmed by the Court of Appeals for the District of Columbia Circuit[7] and by the Supreme Court in Wisconsin v. Federal Power Commission, 373 U.S. 294, 310, (Second Phillips) wherein the Court observed that it shared "the Commission's hopes that the area approach may prove to be the ultimate solution" to the problem of regulating the independent producers.

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[5] 24 FPC 537.

[6] 24 FPC 818.

[7] Wisconsin v. Federal Power Commission, D.C. Cir., 303 F.2d 380.

The first area rate proceeding was that for the Permia Basin and was initiated on December 23, 1960.[8] It wa followed by a similar proceeding for the South Louisian area,[9] for the Hugoton-Anadarko area,[10] and for th Texas Gulf Coast area.[11] The last three are in the hearin stage. The Permian Basin proceeding was decided b Opinions Nos. 468 and 468-A to which we turn.

2. *The Decision of the Commission.*

The 131-page original opinion, No. 468, followed b the 23-page opinion denying rehearing, No. 468-A, nee only be summarized at this point. The Commission foun the area rate principle free from constitutional and statu tory objections and adopted it. Contract prices were re jected as a basis for regulation and the reserves to pro duction ratio was declared to be an inappropriate regu latory standard. The Commission set up a two-price sy tem. It differentiated between gas produced as the sol product of a well, referred to as gas-well gas, and gas pro duced in association with oil, known as oil-well gas c casinghead gas. One price was established for new ga well gas and the residue therefrom sold under contract made on or after January 1, 1961. A second price wa established for flowing gas which was defined to includ gas-well gas sold under contracts executed before th mentioned date, casinghead gas, and residue gas derive from either source. The January 1, 1961, date of divisio between new gas-well gas and old gas-well gas wa

[8] Docket No. AR61-1, 24 FPC 1121.
[9] Docket No. AR61-2, 25 FPC 942.
[10] Docket No. AR64-1, 30 FPC 1354.
[11] Docket No. AR64-2, 30 FPC 1354.

adopted because that was the approximate date when the industry became able to direct its exploration efforts toward finding gas-well gas as distinguished from finding gas as a by-product in the search for oil. For new gas-well gas the Commission fixed a rate of 16.5 cents per Mcf for the Texas Railroad Districts inclusive of state and local taxes and a rate of 15.5 cents per Mcf for the New Mexico counties exclusive of applicable state and local production taxes. For flowing gas the respective rates were 14.5 cents and 13.5 cents.

In determining these rates the Commission gave consideration to composite costs but treated the two categories of new gas-well gas and flowing gas differently. It said that the price of the former "was geared to the cost of finding and producing future gas supplies and as such was built up primarily from nationally published statistics and the questionnaire data." For flowing gas it said "our touchstone is the historical cost of gas being produced in the Permian Basin area."

The Commission required adjustment on an individual company basis from the stated prices to reflect differentials from the quality standards. These downward adjustments are determined "by the net cost of processing the gas to bring it up to standard." A downward adjustment is also required if the Btu content is less than 1,000 per Mcf and an upward adjustment is permitted if that content is above 1,050.

Small producers, defined as those making less than 10 million Mcf of jurisdictional sales annually, are exempt from the quality adjustments and from certain filing requirements.

The Commission set a minimum price of 9.0 cents per Mcf. Provision is made for special exemption from area rates. Refunds of excess collections are required on an individual company basis. The possibility of changes in area rates is recognized. A moratorium, until January 1, 1968, is declared on rate increases and indefinite escalation clauses are prohibited.

Three commissioners filed separate opinions. With one exception Commissioner O'Connor approved the results reached but said that "the contract price at which most producers are able and willing to operate is just and reasonable" and that "composite costs best serve as a check on average field prices to preclude significant price departures." He disapproved the Btu adjustment saying that an upward adjustment should be applied for all gas having a Btu content in excess of 1,000. Commissioner Ross was critical of accounting methods used and pointed out the need for simplification. He dissented from the division date between new and old gas-well gas. In his view the new gas-well gas price should apply to gas sold after the date of the Commission decision. Commissioner Black said that the allowed 12% rate of return on net investment "is very probably a generous one" but was justified by the special risk of finding substandard gas in the Permian Basin.

3. *Disqualification of Two Commissioners.*

The Continental Group of petitioners urges that Commissioner Black was disqualified to participate in the decision. The Independent Petroleum Association of America, (IPAA) complains of the participation of both

Commissioners Swidler and Black. The claim is that each of them had prejudged the issue of whether substantial competition existed among producers. Additionally, Commissioner Black is accused of personal bias against the producers. The charges stem from public addresses made in 1964.[12] No claim is made that either commissioner prejudged the ultimate issue of a just and reasonable rate. In our opinion no basis for disqualification arises from the fact or assumption that a member of an administrative agency enters a proceeding with advance views on important economic matters in issue. Nothing in the record disturbs the assumption that the two commissioners are "men of conscience and intellectual discipline, capable of judging a particular controversy fairly on the basis of its own circumstances."[13] The cases cited by Continental and IPAA are not in point.[14]

4. *Objections of Texas and New Mexico.*

The states of Texas and New Mexico, besides adopting the briefs and arguments of the Continental Group, assail the Commission decision on grounds peculiar to

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[12] A motion for the disqualification of Commissioner Black was made to and denied by the Commission. We find no similar motion in the record pertaining to Commissioner Swidler.

[13] United States v. Morgan, 313 U.S. 409, 421. See also Federal Trade Commission v. Cement Institute, 333 U.S. 683, 700-703.

[14] In Texaco, Inc., v. Federal Trade Commission, D.C.Cir., 336 F.2d 754, vacated 381 U.S. 739, the charge was precommitment of a commissioner on the guilt of an accused. In Gilligan, Will & Co. v. Securities and Exchange Commission, 2 Cir., 267 F.2d 461, certiorari denied 361 U.S. 896, a similar charge was made against a commission. Amos Treat & Co. v. Securities and Exchange Commission, D.C.Cir., 306 F.2d 260, related to a charge against a commissioner who had previously served as a staff member in the investigation which led to the complaint.

them in their governmental capacity. They say that the public interest, which the Commission is required to protect, includes the producing states as well as the consuming states; that the prices which the Commission has set will cause a cessation or curtailment of exploration and development activities to the serious injury of the economy of the Permian Basin; that waste rather than conservation of a natural resource will result; and that the states and their public entities will suffer severe losses in taxes and royalty payments.[15] Similar arguments were made by West Virginia in Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 607-614, and were rejected by the Supreme Court which said that when Congress passed the Natural Gas Act it "was quite aware of the interests of the producing states in their natural gas supplies" and that nothing in the Act intimates that high prices should be maintained so that "the producing states obtain indirect benefits." The rejection of the state's contentions in Hope requires the rejection of the same contentions here.

Texas and New Mexico also argue that the Commission has unlawfully interfered with their power of taxation. The Commission fixed the rates of gas produced in Texas to include all state taxes and in New Mexico to exclude such taxes. It said that: "In the event of any increase in taxes in Texas or New Mexico, the Commission will consider whether ceiling prices shall be increased and, if so, to what extent." The states' arguments

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[15] In Texas 4.7 million acres of public lands are within the Permian Basin and in New Mexico over 3 million acres. Much of this land is leased for oil and gas and produces royalty income.

are premature. The Commission has allowed all present taxes as a cost item. Nothing in the Commission decision inhibits the states from increasing those taxes. The Commission has said that if they do, it will determine whether such increases should be passed on to the consumer or remain on the shoulders of the producers. The question of whether increased state taxes will unreasonably burden interstate comerce is hypothetical at this stage.

New Mexico complains that the establishment of a ceiling price plus existing taxes for gas produced in its portion of the Permian Basin denies to it the power to provide a tax incentive to producers by reducing the tax. The argument is not persuasive. If the New Mexico tax was reduced, the Commission could properly consider a rate decrease to reflect the tax decrease.

5. *Legality of Area Rates for Permian Basin.*

The problems confronting federal regulation of the natural-gas business, and particularly the independent producers, have been discussed several times[16] and need be only summarized. The interstate gas business is concerned with a wasting, nonreplenishable natural resource subject to production after discovery. At the point where the gas enters interstate commerce there are few buyers

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[16] See opinions of Justice Jackson dissenting in Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 628, and concurring in Colorado Interstate Gas Co. v. Federal Power Commission, 324 U.S. 581, 608; dissenting opinion of Justice Douglas in First Phillips, 347 U.S. 672, 687; dissenting opinions of Justice Clark in First Phillips, 347 U.S. 672, 690, and in Second Phillips, 373 U.S. 294, 315; dissenting opinion of Justice Harlan in Sunray Mid-Continent Oil Co. v. Federal Power Commission, 364 U.S. 137; 159; and Opinion No. 338 of the Commission, 24 FPC 537, 542-548.

and thousands of sellers. The producers range from the financially powerful integrated oil companies to the wildcatters who operate on a shoestring. Their results are measured by the amount of gas produced — not by the amount of money invested. Exploration and development costs are financed out of current income and are charged to expense rather than capital. The uncertainty of the business causes substantial cost and revenue fluctuations not only from producer to producer but also from year to year for the same producer. A regulated commodity, gas, is produced in substantial quantities along with an unregulated commodity, oil. The allocation of costs between them baffles the experts and presents the temptation to use mathematical means of arriving at a predetermined result. The same rate may bring a financial windfall to one producer and a financial disaster to another. The price of gas must be competitive with that of other sources of energy and must be sufficiently attractive to encourage a continued search for new supplies.

In Federal Power Commission v. Natural Gas Pipeline Co., 315 U.S. 575, 582, a case relating to pipeline rates, the Court held that the provisions of the Act were consistent with the due process clause of the Fifth Amendment and within the commerce power. Another pipeline case, Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 602, says that in fixing rates the Commission is "not bound by the use of any single formula or combination of formulae"; that "under the statutory standard of 'just and reasonable' it is the result reached not the method employed which is controlling"; and that the impact of the rate order rather than the theory behind

it is the governing criterion. The "end result" test of Hope was followed in Colorado Interstate Gas Co., v. Federal Power Commission, 324 U.S. 581, 605-606.

Second Phillips, 373 U.S. 294, holds that the Commission did not abuse its discretion in terminating the § 5 investigation of Phillips' rates and substituting an area basis for an individual company basis. The Court reaffirmed the principles announced in Natural, Hope, and Colorado Interstate, recognized the difficulties inherent in the regulation of the price of natural gas, shared the Commission's hopes for the success of the area approach, and observed that the "case might be different if the area approach had little or no chance of being sustained."[17] At the same time, the Court pointed out that "the lawfulness of the area pricing method" was not before it for review.[18] Four justices dissented in an opinion which characterized the area rate policy of the Commission as "a new, untried, untested, inchoate program which, in addition, is of doubtful legality."[19]

In Callery[20] the Court mentioned that the § 7 proceedings before it had at one time been consolidated with the South Louisiana area rate proceedings. Contrary to the argument of the California Distributors the Court did not, tacitly or otherwise, approve area rate regulation. The most pertinent comment is that of Justice Harlan in his concurring and dissenting opinion who said that area

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[17] 373 U.S. 294, 310, 314.

[18] Id. at 308.

[19] Id. at 317.

[20] United Gas Improvement Co. v. Callery Properties, Inc., 382 U.S. 223, 225-226.

pricing "ultimately aims to simplify proceedings under the statute."[20a]

We cannot accept the arguments of the Commission and the California groups that the Supreme Court has determined the validity of area pricing under the Act. We read the decisions to mean that the Court has permitted the Commission to go forward with the area rate experiment and wishes it good luck in the development of a workable procedure which will be free from constitutional and statutory pitfalls.

Governmental price regulation of services and commodities on a group for geographical basis has been upheld in a number of decisions[21] under the federal commerce and war powers and under state police powers. Those supporting the Commission place great reliance on these decisions. The producers painstakingly distinguish each from the case at bar. We decline to be drawn into these tortuous sidepaths because we are convinced that the "translation of an implication drawn from the special aspects of one statute to a totally different statute is

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[20a] Id. at 231.

[21] See The New England Divisions Case, 261 U.S. 184 (ICC - divisions of joint rates); Aetna Insurance Co. v. Hyde, 275 U.S. 440 (Missouri regulation of fire insurance rates); Tagg Bros. v. United States, 280 U.S. 420 (Packers and Stockyards Act of 1921); Nebbia v. New York, 291 U.S. 502 (New York Milk Control Act); United States v. Rock Royal Co-op., 307 U.S. 533 (Agricultural Marketing Agreement Act of 1937); Sunshine Anthracite Coal Co. v. Adkins, 310 U.S. 381 (Bituminous Coal Conservation Act); Bowles v. Willingham, 321 U.S. 503 (Emergency Price Control Act of 1942); New York v. United States, 331 U.S. 284 (ICC - railroad rates); and Ayrshire Collieries Corp. v. United States, 335 U.S. 573 (ICC - railroad rates).

treacherous business."[22] Specific reference need be made to only one decision. Several producers emphasize the statement in Bowles v. Willingham, 321 U.S. 503, 517, that in the Natural Gas Act "Congress has provided for the fixing of rates which are just and reasonable in their application to particular persons or companies." The argument is that by this language the Supreme Court has recognized that regulation under the Act is on an individual company rather than group basis. We do not agree. The statement is dicta and whatever value it might have had as dicta was, in our opinion, destroyed by the blessing which the Court gave area rate making in Second Phillips.

Producers urge that the language of the Act is contrary to regulation on a group basis because all pertinent references to natural-gas companies are in the singular. First Phillips holds that an independent producer is a "natural-gas company" within the purview of the Act. Section 2, the definitions section, provides that "person" means an individual or corporation, and defines "natural-gas company" to mean a person engaged in transportation or sale of natural gas in interstate commerce. Section 4, covering the filing and changing of rates, refers to "any natural-gas company," "no natural-gas company," "every natural-gas company," and "the natural-gas company." Section 5, authorizing investigation and determination of rates, refers to "any rate," by "any natural-gas company" and to "such natural-gas company." Section 7 provides for certificates of public convenience and necessity and uses the terms "a natural-gas company," "no natural-gas

[22] Federal Trade Commission v. Bunte Bros., 312 U.S. 349, 353.

company" and "such natural-gas company." The repeated use of the singular rather than the plural is said to require that the just and reasonable rate of each particular seller be tested with reference to its peculiar circumstances and operations.

Opposing arguments point out that the Act does not prohibit group or area rate making and that § 16 empowers the Commission to perform any and all acts and to prescribe such orders, rules, and regulations "as it may find necessary or appropriate to carry out the provisions of this act."

The basic query is whether the just and reasonable standard applies on an individual company basis or on a group basis. Section 4(a) says that "all rates * * * made * * * by any natural-gas company * * * shall be just and reasonable * * * ." If this means that each producer is entitled to a rate which will return its costs plus a reasonable profit, the inquiry is at an end because the Commission refused to receive individual cost figures.

The Natural, Hope, Colorado Interstate, and Second Phillips decisions all support the conclusion that in the regulation of natural-gas rates the Commission is not bound by any formula or method, and that the choice of the appropriate method for the determination of those rates lies in the sound discretion of the Commission. The appropriateness of the method depends on the peculiar characteristics of the natural-gas industry.

In its Opinion No. 338,[23] the Commission noted the reasons why the individual company cost-of-service

[23] 24 FPC 537.

method was inapplicable and unworkable. Among these were the lack of a fixed determinable relationship between investment and service to the public with the result that "a huge investment might yield only a trickle of gas, while a small investment might lead to a bonanza," the staggering allocation problems which could result in such anomalies as widely varying prices for gas coming from a jointly owned lease or even from a jointly owned well, and the intolerable administrative burden of requiring a separate rate determination for each of the several thousand independent producers.

The powerful contrary argument is that no area rate, whether based on composite costs, average aggregate costs or any other industry wide criteria, will suffice to assure a high cost producer of its costs to say nothing of a profit. We accept this as true.[24] The impact of an area rate in the natural-gas industry may have effects which cover the entire range from bonanza to bankruptcy. It is sufficient for us that these results were lucidly demonstrated in the dissenting opinion of Justice Clark in Second Phillips and did not deter the majority from allowing the Commission to proceed with its area rate program.

Some of the producers argue that if the Act is construed to permit area rate making, the Act is invalid under

[24] An appendix to the Hunt brief presents an array of natural-gas costs of 44 Permian producers whose volumes total over 208 million Mcf. Of these, 16 producing over 170 million Mcf are shown to have costs of less than 14.5 cents. The remainder have costs running from 14.77 cents to 216.05 cents. We have been unable to check the accuracy of these figures and mention them only to show the claimed disparity of costs. Continental says that "approximately 67 percent of the companies and approximately 30 percent of the volumes had costs above the industry average cost level."

Art. I, § 1, of the United States Constitution because no legislative standards have been set for establishing groups or making group determinations. Reliance is had on Panama Refining Co. v. Ryan, 293 U.S. 388, which held that a delegation of legislative power to the President was unconstitutional because Congress, among other things, "has declared no policy, has established no standard, has laid down no rule."[25]

Congress cannot delegate its power to enact laws but it can confer on an administrative agency the power to carry into effect laws which it has enacted.[26] In the New England Divisions Case, supra, the Court referred to the power given by Congress to the Interstate Commerce Commission to determine just and reasonable rates and said that Congress "intended that a method should be pursued by which the task * * * could be performed."[27] In Lichter v. United States, 334 U.S. 742, 785-786, the Court in discussing legislative standards said that the "standards prescribed by Congress are to be read in the light of the conditions to which they are applied" and for an example observed that "among those which have been held to state a sufficiently definite standard for administrative action [are] 'just and reasonable' rates for sales of natural gas."

In the regulation of the natural-gas industry "the actual necessities of procedure and administration"[28] have led to the adoption of the area rate method. We believe that

[25] 293 U.S. 388, 430.

[26] Crain v. First National Bank of Oregon, Portland, 9 Cir., 324 F.2d 532, 537.

[27] 261 U.S. 184, 197.

[28] Id. at 198.

neither constitutional nor statutory provisions prevent the use of that method and that the Commission did not abuse its discretion in adopting it. The more important and difficult question is that of the validity of the area rates which have been established. The controlling standard is the end result test of Hope. In our opinion, this test is accepted by, and reaffirmed in, the Second Phillips decision.

Some of the producers urge that the area rate method is not consistent with the characteristics of the industry and that contract prices satisfy statutory requirements because they have been reached through effective competition. The Commission considered and rejected the argument. It pointed to the history of price negotiations in the Permian Basin, to the urgent requirements of the pipelines, to the heavy percentage of sales by a few producers, and to the control of undisclosed and uncommitted gas reserves by a few producers. It concluded that the record fails to establish that a just and reasonable rate can be established through competition and that "the primary competition revealed by the record was among the pipelines to secure new gas supplies at higher prices." Commissioner O'Connor disagreed saying that "the contract price at which most producers are able and willing to operate is just and reasonable." His conclusion was that "profit oriented costs and supply oriented contracts do not, in the aggregate, depart in any significant manner from each other." We accept the conclusion of the Commission that competition has not been effective to fix a just and reasonable rate. It is supported by reasonable inferences from the record and they are binding on us.

Continental and Superior say that they were improperly denied an opportunity to be heard on the geographical propriety of the Permian Basin as a rate area. In its order instituting the proceedings the Commission eliminated the issue of the appropriateness of the area for rate making purposes.[29] The Commission may draw on its expertise to determine the ground rules for an investigation but in so doing may not deny a specific right.[30] The producers fail to convince us that any such denial has occurred here. The Permian Basin is a well known area. Unless prices are to be determined on a national basis, areas must be selected and defined. The Commission had two choices. It could first determine the national revenue requirement and divide that up among the areas or it could first determine the various rates so that in the aggregate they meet that requirement. We are unwilling to assume that when all the area proceedings are completed the total revenue will not equal the national requirement. If it does not, both the producers and the consumers will suffer. In our opinion the Commission acted reasonably in selecting the Permian Basin for an area rate proceeding.

6. *The Two-Price System.*

The Commission's two-price system is vigorously attacked on many fronts. It will be remembered that one price is fixed for new gas-well gas and another for flowing gas. All agree that gas is a commodity which is valuable as a source of energy. The householder does

[29] 24 FPC 1121, 1122.

[30] Amax Petroleum Corporation v. Federal Power Commission, 10 Cir., 350 F.2d 92, 94.

not care whether the gas which burns at the tip of his appliance comes from a gas well, an oil well, or as a residue product. To him gas is gas.

The justification for the two-price system is that the higher price for new gas-well gas provides an incentive to explore for and develop new supplies. The producers do not question the finding that "the industry is increasingly becoming able to direct its exploration efforts toward finding new gas-well gas as distinguished from finding gas as a by-product in the search for oil." This ability may be confined to the larger companies which maintain the technical staffs skilled in making the necessary predictions. The smaller producers are in a less advantageous position. They may be relegated to the farmouts which the majors pass down to them or to operations in accord with their less scientific but sometimes financially rewarding hunches.

New gas discoveries are well said to be the life blood of the industry. The consumers may reasonably be required to pay the price needed to bring forth such discoveries. If an incentive price based on current costs is used for all gas, windfalls will be assured to many producers of old gas developed under lower historical costs and often found in association with oil.

The producers say that a single-price system based on current costs is required because revenues for current exploration and development must be internally generated from sales of gas from whatever source. The Commission rejected the argument. The question is not so much the source of the funds as it is the inducement to use available funds in the search for gas. The higher

price for new gas is intended to supply that inducement. Although the adequacy of the inducement can only be tested by future developments, we are not convinced that the refusal of the Commission to include the same inducement in the price of old gas, with the resulting likelihood of windfalls, was unreasonable.

Continental, Phillips, and others argue that the two-price system amounts to entrapment because of the possibility of reduction in price after financial commitments have been made. Although the Commission which announced the Permian Basin decision cannot bind a future Commission, we credit the Commission with good faith. The possibility of a change does not invalidate the rate method employed. When and if a reduction occurs, the argument of entrapment can be heard.

The division date of January 1, 1961, for the different prices of new gas-well gas and old gas-well gas is another subject of dispute. Here the Commission found as a fact that the appropriate date was the approximate time when directional drilling came to be used effectively. Under the evidence the selection of a division date was an administrative problem calling for the exercise of judgment. In making its choice the Commission acted within the evidence and within its powers. On rehearing, the Commission left open for future consideration the problem arising when new gas-well gas is developed from committed acreage. We assume that this problem will be met fairly when it comes to a head.

The two-price system is an outgrowth of directional drilling for gas. Its purpose is to assure a continued gas supply. The Commission frankly says that the adoption

of the system for the Permian Basin "should serve to furnish a practical test of whether in fact it will result in bringing forth additional supplies." We find no persuasive reason why the test should not be made.

7. *The Cost Information.*

In arriving at the Permian Basin rates the Commission used many sources of cost information. These included responses to questionnaires sent to producers, the Census of Mineral Industries for 1958, the Chase Manhattan Bank's 1961 Annual Analysis of the Petroleum Industry, the World Oil Magazine, the Oil and Gas Journal, the Joint Association Survey,[31] and others. The producers attack these sources on many and varied grounds. The range of objections runs from hearsay evidence through deprivation of right of cross-examination to denial of procedural due process. To take up each of these objections would increase the length of this opinion to encyclopedic dimensions.

From the information so obtained the parties, the staff, and the Commission make many computations and reach many results. The assumptions, allocations, formulae, equations, averages, means, and massive calculations may intrigue a mathematician or statistician but they have no attraction for us. We respectfully decline to be drawn into such a turmoil of numbers. We cannot in a few months unravel the snarl of statistics developed in the years of hearings. In our opinion the judicial process,

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[31] This is a survey of a few producers conducted by the American Petroleum Institute, the IPAA, and the Mid-Continent Oil and Gas Association.

in cases such as this, should be confined to consideration of errors of law. We leave to the experts the selection of source material and the calculations to be made therefrom. Our concern is with the result.

8. *The Commission's Price Determinations.*

The Commission said that "costs must be a major factor in determining the area price." On the basis of current national statistics plus questionnaire data it determined the 1960 Mcf cost of new gas-well gas thus:

Exploration and Development Costs	
Dry Holes	1.42 cents
Other Exploratory Costs	1.59
Adjustment for Exploration in Excess of Production	1.11
Production Operating Expense	2.70
Net Liquid Credit	(3.10)
Regulatory Expense	.14
Depletion, Depreciation, and Amortization of Production Investment Costs	
Successful Well Costs	2.88
Lease Acquisition Costs	.76
Cost of Other Production Facilities	.31
Return of Production Investment (at 12%)	5.21[32]
Return on Working Capital	.35
Subtotal	13.37
Royalty at 12½ percent	2.05
Production Taxes	1.01
Total	16.43

[32] This is computed as follows: The production investment is the sum of successful well costs, lease acquisition costs, and cost of other production facilities or a total of 3.95 cents. It is to be recouped over an average period of 10 years beginning an average of one year after investment. Accordingly, the return is allowed on an investment base 11 times the production investment of 3.95 cents per Mcf or 43.45 cents. 12% of this figure is 5.21 cents per Mcf.

The Commission rounded this figure off at 16.5 cents for the Texas production. Because the New Mexico figure is exclusive of taxes a reduction of one cent was made in the New Mexico price.

For the costing of flowing gas the Commission used historical data developed by the industry questionnaires. The results may be summarized thus:

Production operating expenses	1.75 cents
Depreciation, depletion and amortization	2.42
Return at 12%	4.99
Exploration and development	4.08
Regulatory expense	.14
	13.38
State production tax at 7%	1.01
	14.39[33]

This figure was rounded off at 14.5 cents for Texas and 13.5 cents for New Mexico. As a check on the method used the Commission back-trended the new gas-well gas figures and arrived at a 14.64-cent price.

The rates so established are subject to downward adjustment because of quality deficiencies and to both downward and upward adjustments on the basis of Btu content. The Commission disclaims any intent that the rate figures show producer costs. It says that the price of new gas-well gas is "geared" to costs derived from national statistics and the questionnaire data and that for flowing gas the "touchstone" is the historical price of Per-

[33] No separate item was included for royalty payments because costs were computed on ⅞ of actual volumes.

mian gas.[34] Other undefined and unidentified "factors" were taken into consideration.

9. *The Moratorium.*

The Commission implemented the price provisions of the decision in various ways. It imposed a moratorium on rate increases until January 1, 1968, "except in compliance with a specific order of the Commission for a rate as determined pursuant to said proceeding [AR61-1] or pursuant to later order of the Commission." The producers say this violates the Act because § 4 permits filings for rate increases. Section 4 must be read with other sections of the Act. Section 5 authorizes the Commission to determine the just and reasonable rate "to be thereafter observed and in force." Section 16 gives the Commission power to make such orders "as it may find necessary or appropriate to carry out the provisions of this act." In Callery the Court held that there was ample power under § 7(e) to impose a moratorium.[35] We believe that there is also ample power under §§ 5(a) and 16. The reasonableness of the exercise of the power is established by the need for price stability, the Commission's expressed willingness to reopen the proceedings to consider the propriety of changes, and the expiration date which is only about a year off.

10. *The Escalation Clauses.*

The Commission's order forbids the filing of rate changes in excess of applicable area rates when the con-

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[34] In Opinion No. 468 the Commission said: "Nevertheless, we make clear that we do not confine ourselves to a cost calculation in determining just and reasonable rates."

[35] 382 U.S. 223, 228.

tractual, right thereto is based on indefinite escalation clauses not permitted by § 154.93(a), (b), and (c) of the Regulations under the Natural Gas Act. The producers say that this provision destroys existing contract rights. The Commission replies that it has not proscribed the clauses but merely the right to file under them. This is a thin distinction. In Pan American Petroleum Corporation v. Federal Power Commission, 10 Cir., 352 F.2d 241, 245, we upheld § 154.93 and pointed out that if a producer felt aggrieved thereby it could apply for a rule waiver under § 1.7(b) of the Commission's Rules of Practice and Procedure. We assume that a similar request could be made under the Permian order. When the request is made and rejected, the time will arrive for the consideration of the constitutional questions which the producers raise.

11. *The Commission's Fair Relationship Standard.*

In fixing the amounts of the area rates the Commission rejected the end result test and adopted a fair relationship standard. This appears clearly from Opinion No. 468-A. After disclaiming that it had made any finding that "jurisdictional revenues will equate to jurisdictional costs," the Commission said:

> "* * * we are convinced that the record fully justifies the Commission's judgment that the ceiling prices we have fixed 'provide a fair relationship between the aggregate price the consumer pays and the aggregate costs that the producers incur' in the Permian Basin."

Hope says that in the fixing of just and reasonable rates there must be a "balancing of the investor and the consumer interests."[36] It goes on to say that from the com-

[36] 320 U.S. 591, 603.

pany point of view the revenue must not only provide operation expense but also capital costs including "service on the debt and dividends on the stock"; and that the return to the equity owner must be commensurate "with returns on investments in other enterprises having corresponding risks" and "sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital."[37] The Court concluded the discussion of this problem with the observation that in Hope the "end result" could not be condemned as unjust and unreasonable.

In Colorado Interstate Gas Co. v. Federal Power Commission, 324 U.S. 581, 605, the Court, after referring to the Natural and Hope decisions said:

> "In those cases we held that the question for the courts when a rate order is challenged is whether the order viewed in its entirety and measured by its end results meets the requirements of the Act."

Also pertinent is the statement of the Court in Second Phillips that:[38]

> "To whatever extent the matter of costs may be a requisite element in rate regulation, we have no indication that the area method will fall short of statutory or constitutional standards. The Commission has stated in its opinion in this proceeding that the goal is to have rates based on the 'reasonable financial requirements of the industry' in each production area, * * * and we were advised at oral argument that composite cost-of-service data will be considered in the area rate proceedings."

Nothing in Second Phillips rejects the end result test of Hope. We believe that it applies here and that it is not

[37] Ibid.

[38] 373 U.S. 294, 309-310.

satisfied by a finding of fair relationship. Something more than mere semantics is involved. The determination of a fair rate from the standpoint of the consumers must depend to large extent on the informed judgment of the regulatory agency. In these proceedings no distributor, consumer interest, or consumer representative objects to the rates. They are accepted as just and reasonable.

From the standpoint of the producer the situation is different. It is entitled to recover its prudent operating expenses and capital costs with a return commensurate to the risk and sufficient to attract capital. These requirements must be tested against the record. They may not be brushed aside with a general finding of fair relationship. The Commission concedes that it did not equate jurisdictional costs to jurisdictional revenues. This is obvious because no determination was made of the jurisdictional revenues which the rates will produce.

12. *The High Cost Operator and the Small Producer.*

The Commission broke down the rates into components which it justified on averages based on national statistics and questionnaire data. We recognize that weighted averages and sifted averages are suspect.[39] We accept the principle that both the basic figures and the averages obtained therefrom must be typical and representative but we are not convinced that the Commission has misused its expertise in this technical field. It is self-evident that when average costs are used to compute ceiling prices, the high cost operator will be hurt and some low cost operators may receive windfalls. Probably

[39] See United States v. Abilene & Southern Railway Company, 265 U.S. 274, 291, and Interstate Commerce Commission v. Mechling, 330 U.S. 567, 583.

to a greater extent than in any other comparable segment of the national economy the element of chance can affect the success or failure of even the most prudent entrepreneur who engages in the natural-gas business.

The problem of the high cost operator is characteristic of group or area rate making. The Supreme Court upheld group rates in Acker v. United States, 298 U.S. 426, 431, and commented that "regulation cannot be frustrated by a requirement that the rate be made to compensate extravagant or unnecessary costs." In Tagg Brothers v. United States, D.C.Neb. 29 F.2d 750, 755, affirmed 280 U.S. 420, the court said that it was not necessary "to fix the rates so high that all agencies in the business would make money." Covington & Lexington Turnpike Road Company v. Sanford, 164 U.S. 578, 596, says that "the public cannot properly be subjected to unreasonable rates in order simply that stockholders may earn dividends."

The small producers, represented here by Big Chief Drilling Company, IPAA, Texas Independent Producers & Royalty Owners Association (TIPRO), J. C. Barnes, and others, join in the prediction that the Permian decision sounds the death knell of the small producers. Perhaps the flamboyant wildcatter must be replaced by the scientists of the industrial giants but the efforts of the boom-or-bust adventurers have contributed greatly to natural-gas discoveries. In its decision the Commission referred to the "smaller independent who traditionally drills much of the Permian exploratory acreage" and said that: "Consumers and the natural gas industry alike have a strong stake in the continuation of the exploration efforts of the thousands of small operators who con-

tribute a large share of the discoveries of new sources of gas."[40]

The Commission took note of the suggestions that small producers should be exempt from regulation.[41] It found that outright exemption was neither necessary nor desirable but said that the small producers needed "special treatment." To this end it defined a small producer as "a natural gas company selling jurisdictionally less than 10,000,000 Mcf annually on a nationwide basis." They were granted relief from various requirements of §§ 7 and 4 and were freed from rate adjustments because of quality differentials. In our opinion the classification is reasonable and within the Act.

The small producers do not seek complete exemption. Their attitude is that such relief would be illusory rather than real because the pipelines would not pay more for gas supplied by them than the price paid to the major companies. Their complaint is that the Commission did not give adequate consideration to small producers' costs.

Data covering the costs of Permian producers came from questionnaires which are classified as Appendix B and Appendix C. The Appendix B group was mandatory for producers with company-wide jurisdictional sales of over 10 million Mcf and optional for others.[42] The

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[40] Big Chief asserts that the small producers, although credited with only 20% of current production volumes, actually drill almost 40% of all successful gas wells and 50% of all successful exploratory gas wells.

[41] See statements of Justice Clark dissenting in Second Phillips, 373 U.S. 294, 329-330, and speaking for the Court in Federal Power Commission v. Hunt, 376 U.S. 515, 527.

[42] Appendix A pertained to well and drilling statistics. It is not pertinent here.

Appendix C questionnaires went to the small producers. Forty-two of the majors and 25 of the small producers answered Appendix B. The response to the Appendix C questionnaires was sporadic. The Commission used only the material supplied by the majors saying that the inclusion of the data supplied by the small producers "does not affect the results.".

TIPRO and Big Chief both emphasize the testimony of a staff witness that the small producer questionnaire showed average unit costs 2 cents per Mcf higher than those of the majors. They argue that the end result standards must be applied not only to the entire group but to them as a group. The weakness of the argument is that once the whole group is split the process can be carried on until the regulation is back on an individual company basis.

We do not know the answer to the small producer problem. Superficially it seems unfair to fix ceiling prices for all producers, both large and small, on the basis of the costs of large producers only. The Commission rejected the small producer data because in its opinion the impact on the rate structure was de minimis. On the record presented, we are unwilling to say that this conclusion was erroneous as a matter of law.

In any regulation of the natural-gas industry on an area basis the high cost producers, be they majors or little fellows, are certain to be placed in a position less advantageous than that occupied by those whose good fortune and able management have supplied a lower cost base. We agree with the Commission that the expense items included in an individual cost-of-service are not

the measure of a confiscatory rate. A producer has no constitutional right to be reimbursed for dry-hole expenses.[43] Also it has no obligation to remain in business by replenishing the supplies of gas which form the basis of present obligations. Inability to continue exploration and development is not confiscation. We conclude that the impact of the Permian rates on the high cost producers does not destroy the area rate method.

13. *Gathering and Processing Costs.*

One subject of much discussion in the briefs is the allowance of the same rate for gas delivered at the tailgate of a processing plant and for gas delivered at the wellhead. Gathering lines cost money and have to be built and operated by someone. The Commission's position is that the revenues received for oil and oil products derived from condensation and processing return a profit which induces the building of the needed gathering lines and plants. Here again we reach the troublesome field of cost allocations between a regulated commodity, gas, and unregulated commodities, oil and liquified petroleum products.

Bass places particular emphasis on this phase of the case. It points to its extensive investments in gathering lines and plants and to its permanently certificated rate of 18 cents which, it says, the Commission has never specifically found unreasonable or discriminatory. The answer as we see it is that if area rates are proper no greater need exists for the consideration of the individual cost and revenue requirements in the case of Bass than

[43] Cf. Columbus Gas & Fuel Co. v. Public Utilities Commission of Ohio, 292 U.S. 398, 407.

in the case of the other producers. Perhaps in the future courts will have to explore the mysteries of allocations but we are not so inclined in this case. If in fact Bass and others similarly situated are confronted with confiscation, a way must be open for them to be heard.

14. *Special Exemptions.*

The Commission recognized that some provision must be made for special exemption from area rates. It said that when a producer's "out-of-pocket expenses in connection with the operation of a particular well are greater than the revenues under the applicable area price, he should be entitled to appropriate relief." It declined to "specify all of the special circumstances which may serve as a basis for exceptions to the area rate" and observed that failure to earn exploration and development expenses plus the allowed return does not amount to confiscation. In regard to the form of relief it held that "it may be sufficient to permit them to abandon their unprofitable sales."

We agree with the Commission that an escape clause cannot be used to convert an area rate into an individual company cost-of-service rate but an escape clause which does no more than prevent an unconstitutional confiscation amounts to nothing. None is needed for that purpose. The producers are right in saying that the Commission's exemption provisions are so vague and nebulous that neither they nor a court can determine what relief is being granted. Out-of-pocket expenses are not defined and we do not know what they include. If a producer's accounting is on a lease rather than well basis, the facts relating to a particular well might not be determinable.

It may be going too far to say categorically that individual producers should be permitted to show that the group costs are not typical or representative of their costs but in some instances that should be permitted. Conservation of gas is promoted if marginal wells are allowed to continue to produce but is discouraged if the same wells are shut down by a low price. Some producers furnish gathering facilities. Others sell at the wellhead and the pipelines pay for the gathering. Gathering costs are allowed pipelines. Perhaps in some instances they should be allowed to producers. An adequate savings clause should contain guidelines which if followed by an aggrieved producer will permit it to be heard promptly and to have a stay of the general rate order until its claim for exemption is decided. It is not enough to say in effect that confiscation will be prevented. Confiscation is an individual proposition and the individual is entitled to be heard. We are convinced that the Commission's special exemption provisions are inadequate.

15. *Quality Standards.*

The Commission provided for adjustments in the area rates to reflect quality differentials. It said that "the price of gas cannot be related to volume alone but must be related to units of energy free of impurities and sufficiently compressed to enter the pipeline." Standards were fixed for content of carbon dioxide, hydrogen sulphide, total sulphur, water, and other impurities; and the amount of delivery pressure was established. The applicable base area rate is adjusted downward by the net cost of processing the gas to bring it up to standard. Provision is made for both an upward and a downward adjustment of rate depending on the Btu content. Quality

statements are required to be filed together with an agreement by the seller and the buyer covering the cost of bringing the gas up to standard. If an agreement cannot be reached, each shall file a statement of its views on the processing costs.

About 90% of the flowing gas is substandard. We are cited to no figures on the similar percentage of new gas-well gas. The amount of the rate adjustments does not appear in the record because there was no evidence of the extent of quality differentials or of the processing costs of bringing the gas up to standard.[44] At oral argument various estimates were given as to the amount of rate reduction which would result from substandard quality. These were based on statements filed pursuant to the decision but after the record was closed. They ranged from .7 cents to 2.0 cents per Mcf. A spokesman for the Continental Group said that on 1960 volumes a revenue deficiency of some $12 million a year would result. The Commission response in this court to the Skelly motion for stay of the Commission's orders herein said that the reductions in applicable rates because of adjustments for quality standards are expected to result in a revenue reduction of about $10 million annually.[45]

The producers' argument that the imposition of quality standards violates procedural due process because of lack

[44] The Commission says in its brief that "appropriate price differentials or adjustments could not be made on the basis of the record."

[45] The statement was this: "It has been estimated that the reductions to the base rates alone will reduce the revenues from jurisdictional Permian sales by about $10 million annually. The adjustments for quality standards, which were substantially altered by Opinion 468-A * * * are expected to result in a further reduction of the same magnitude."

of notice need not be resolved at this time. We are remanding the case and now everyone has notice. The matter of the Btu adjustments presents a particular problem which was emphasized by Commissioner O'Connor in his dissent. The price goes down if the Btu content is below 1,000 and goes up if it is above 1,050. The producers say the adjustment upward should begin at 1,000. We do not understand the Commission's reasons for the gap. On remand this can be clarified.

16. *The Rate of Return.*

The Commission says that the impact of the quality adjustments is taken care of in the rate of return which is made generous on this account. It fixed a rate of return of 12% on production activities and held that such rate "protects gas consumers against excessive prices but it is not so low that it fails to respond to the needs of the industry." The principles applicable to the determination of an appropriate return are set forth in Bluefield Water Works & Improvement Co. v. Public Service Commission, 262 U.S. 679, 692-693. It "must be determined by the exercise of a fair and enlightened judgment, having regard to all relevant facts." The rates of a public utility should "permit it to earn a return on the value of the property * * * equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties" but the utility has no constitutional right to profits realized by "highly profitable enterprises or speculative ventures." The return should assure "confidence in the financial soundness of the utility" and be adequate under prudent management "to maintain and support its credit and en-

able it to raise the money necessary for the proper discharge of its public duties." The Hope decision[46] states the same basic principles.

The Commission recognized these controlling principles. The objections of the producers are to the point that the allowed rate of return is inadequate to enable the industry to attain the goals which the principles contemplate. At this time there is no need for us to go into the comparisons of the returns appropriate for producers as opposed to pipelines or to the financing methods employed by either. The fact is that by treating quality deductions as a risk rather than a cost the Commission has made it impossible to determine the amount of return with any degree of certainty. The difficulty is that the record does not disclose the amount of deductions.

A fair rate of return cannot be ascertained with mathematical certainty.[47] Pragmatic adjustments may be made by an agency within the ambit of its statutory authority.[48] A court must put great reliance on agency expertise in evaluating a rate of return but this does not mean that a court must accept the agency determination in blind faith. A producer is entitled to a higher rate of return than a pipeline because of the greater risk of the business. The Commission has here compounded the risk of discovery with the risk of substandard quality.

We believe that the price reductions to reflect quality deviations are an item of cost rather than an item of risk

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[46] 320 U.S. 591, 603.

[47] Colorado Interstate Gas Co. v. Federal Power Commission, 10 Cir., 142 F.2d 943, 961-962, affirmed 324 U.S. 581.

[48] Federal Power Commission v. Natural Gas Pipeline Co., 315 U.S. 575, 586.

and should be directly reflected in the applicable base rates instead of hidden in a rate of return allowance. The amount of cost is the expense of bringing the quality up to standard. In the Permian Basin sound reason exists for this conclusion because of the known and substantial quality deficiencies particularly in flowing gas production. We find it hard to understand why a revenue deficiency in the estimated amount of $10 million annually should be classified as a risk and not a cost. A risk occurs as the result of unknown or unconsidered contingencies. In the Permian Basin it is known and considered that flowing gas falls short of pipeline standards. In any event, the lack of evidence as to quality deductions makes it impossible to determine whether the rate of return satisfies the Bluefield and Hope principles and we have no basis on which to appraise the allowance made by the Commission. We respect the expertise of the Commission but the conclusions reached by the use of expertise must accord with legal standards.

17. *Contract Limitations.*

The producers say that recovery of industry costs under the area rates is impossible because many of the existing contracts do not permit a producer to file for the flowing gas ceiling price of 14.5 cents. The Commission recognized that "there undoubtedly will be some contract prices lower than the area rate ceiling, as adjusted for quality." Some of the producers estimate the deficiency because of contract limitations to be $14.4 million in the test year of 1960. The Commission has estimated that a reduction of base rates alone will result in a revenue reduction of about $10 million annually.[49]

[49]See supra, note 45.

It is elementary that gas prices are originally set by contract between the producer and the pipeline, that the producer may not raise the price unilaterally, and that any increase in price must be within contract terms unless the price is set so low as to affect the public interest. The Commission says that the producers are not entitled as a matter of right to collect contract rates that are higher than otherwise reasonable in order to offset other rates limited by contract to below maximum reasonable levels. Regulation does not guarantee an over-all profit;[50] relief from an unduly low rate may be given only if the rate is "so low as to adversely affect the public interest — as where it might impair the financial ability of the public utility to continue its service, cast upon other consumers an excessive burden, or be unduly discriminatory";[51] and a company's losses in one instance do not justify an illegal gain in another instance.[52] At the same time in such group procedures as the division of railroad rates the Interstate Commerce Commission, with court approval, has recognized that revenue from one source may balance that from another.[53]

Contract limitations are one of the facts of life for the natural-gas industry. They are the outgrowth of the days when gas, which had previously been vented, flared, or capped, became salable to the newly constructed inter-

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[50] Federal Power Commission v. Natural Gas Pipeline Co., 315 U.S. 575, 590.

[51] Federal Power Commission v. Sierra Pacific Power Co., 350 U.S. 348, 355.

[52] Federal Power Commission v. Tennessee Gas Transmission Co., 371 U.S. 145, 153.

[53] See New England Divisions Case, 261 U.S. 184.

state pipelines. The pipelines wanted long-term contracts and the producers wanted to sell their gas. Prices were low. With the phenomenal increase in the use of gas as an energy source the prices rose. The producers whose contracts either contained no escalation clauses or clauses of the type proscribed by the Commission were in a disadvantageous position. Even permissible escalations do not, in many instances, bring the 1960 price up to the area ceiling. In Second Phillips the Court upheld the termination of certain § 4(e) dockets on the Commission's finding that "the annual increase in revenue produced by these increased rates was substantially less than the deficit for the test year 1954."[54] The same situation exists here for many companies. We do not know whether it exists for the area producers as a group because no finding was made of revenue and requirements. The Supreme Court has said that losses in one instance do not justify illegal gains in another. To us this means that the contract limitations do not preclude the establishment of a just and reasonable area rate. The answer is provision for a minimum rate.

The Commission held that "the establishment of minimum rates in this case is in the public interest and that the price impact on the consumer will be de minimis." It established a minimum rate of 9 cents per Mcf for gas of standard pipeline quality. We believe that the controlling question is whether the proper revenue requirements of the area producers as a group can be satisfied with rates having the ceiling and the floor which the Commission has fixed. This cannot be answered because

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[54] 373 U.S. 294, 305.

the financial impact of the quality deductions is not ascertainable from the record.

18. *Refunds.*

The revenue deficiency argument of the producers leads directly to the refund issue. The Commission required "appropriate refunds in the case of rates which are the subject of proceedings under Section 4(e) of the Act, and have thus been collected subject to an obligation to refund amounts collected in excess of the just and reasonable rates as here determined." Procedures to accomplish this result were set up in detail.

The producers say that these individual company refunds are not proper because of the revenue deficiency of the industry. They say that in the test year of 1960 the producers in the area failed to meet their revenue requirements by $14.4 million and they estimate the refunds for that year under the Commission decision to approximate $6 million.

The Examiner held that refunds should be ordered only to the extent that over-all industry revenues exceed over-all industry expenditures in a given year. The Commission said that this theory was unworkable because it would result in inequities among both the buyers and the producers and because of "insurmountable" administrative difficulties. We are at a loss to understand how refund obligations, which might come into existence under the Examiner's approach, would be divided among the producers.

We see no escape from the requirement that refunds be on an individual company basis and on a schedule by

schedule basis. As we understand Federal Power Commission v. Tennessee Gas Transmission Co., 371 U.S. 145, 153, refunds are appropriate for each excessive rate regardless of over-all revenues. The Commission has required refunds only on § 4(e) rate increases above the applicable area ceiling. If a producer claims that the refunds required of it are confiscatory or harmful to the public interest, it must have an opportunity to petition for special relief. A similar opportunity must be afforded if a producer can show that a refund is required for collections at or below the "last clean rate."[55] An adequate special exemption clause can take care of such situations.

19. *The End Result Test.*

This brings us back to the end result test. The Continental Group, which includes many large producers and major integrated oil companies and which is supported by Phillips, presents alternative arguments. The first is economic. It is said that regulation under the Act must be consistent with the economic characteristics of the industry; that this requires the establishment of market prices based on contracts; that a cost-based system of regulatory rates does not recognize the responsiveness of the gas supply to gas prices; and that a producer does not explore on the expectation of a return of its cost plus a return on its investment but on the hope of getting back many times what it expends as a reward for its gambler's risk. No doubt these are the economic facts of the industry.

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[55] By "last clean rate" is meant the last rate in effect pursuant to a permanent certificate not subject to any refund obligation.

The divorce of commodity value from costs was suggested by Justice Jackson in his dissent in Hope. He commented that a producer would have difficulty showing the invalidity of a fixed commodity value so long as it voluntarily continued to sell its product in interstate commerce.[56] One difficulty with this suggestion is that once the gas is committed no withdrawal from interstate movement is possible without Commission approval.[57] A producer can stop exploration and development if it is dissatisfied with price but the interstate sales go on with a continuing impact of cost on price and of price on exploration and development. In any event the majority rejected the proposal and held that under the just and reasonable standard of the Act a regulated company is entitled to revenue for operating expenses and capital costs and to a return "commensurate with returns on investments in other enterprises having corresponding risks."[58] These standards cannot be met without consideration of costs and revenues. In our opinion the Hope construction of the statutory standard casts serious doubts on the validity of the adoption of a contract-based commodity value.

The alternate argument of the Continental Group is that if the rates are to be determined on a composite cost-of-service basis, the revenue requirements of the industry must be found and rates fixed to meet those requirements. In Second Phillips the Court particularly noted the assurance of the Commission that "composite cost-of-service

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[56] 320 U.S. 591, 652.

[57] Section 7(b) of the Act. See also Sunray Mid-Continent Oil Co. v. Federal Power Commission, 364 U.S. 137, 156.

[58] 320 U.S. 591, 603.

data will be considered in the area rate proceedings."[59] Consideration of such data does not eliminate consideration of other factors. At the same time Second Phillips did not reject the end result test of Hope. Instead it quoted a portion of that opinion which said among other things that "it is the result reached not the method employed which is controlling."[60]

The Commission rejected both alternatives of the Continental Group. It said that commodity value established by contracts may not be used because of the absence of effective competition; and it emphasized that it took into consideration factors other than costs. The record does not disclose what these other factors were but they must have had some economic basis. The Commission held that its ceiling prices provided a "fair relationship" between consumer prices and producer costs. Fair relationship is pertinent but it is only part of the end result test. We do not know the producers' costs or revenue requirements. We do not know the economic factors which either require or permit departure from costs and revenues. The end result test is not satisfied by a reliance on unknowns.

We have accepted the Commission's conclusion that contract rates should not be used. The trouble is that the Commission decision rides two horses and we have no way of knowing the outcome of the race. It uses composite cost-of-service evidence, engrafts economic factors on top, and comes out with a rate which it justifies on a fair relationship basis. We have the problem of how in such circumstances a court can determine whether the

[59] 373 U.S. 294, 310.

[60] Id. at 309.

just and reasonable standard of §§ 4 and 5 has been met. The answer is not found in the record before us.

The facts sustaining the conclusion of fair relationship must be found. The Commission did not make those findings and indeed it could not have done so because of the failure of the record to disclose the revenue impact of the adjustments in area rates to reflect quality differentials. Whether rate reductions because of quality deficiencies are a risk or a cost, the answer comes out the same. If they are a risk, we do not know the rate of return. If they are a cost, we do not know whether the revenue received will equal the reasonable revenue requirements. We believe that under Hope, and under Second Phillips, the area producers, as a group, are entitled to recover their prudent operating expenses and capital costs with a return commensurate to the risk and sufficient to attract capital. Satisfaction of this requirement must appear through appropriate findings based on substantial evidence. These cannot be made on the record presented. The decision of the Commission is not saved by the special exemption provisions which we find to be insufficient and unsatisfactory.

Rate making under the Act has produced a superabundance of delay and litigation. Much gas has moved through the pipelines since the First Phillips decision. We wonder if the time has not come for the establishment of a better rapport among the Commission, the consumers, the distributors, the pipelines, and the producers. Some practical means of resolving the economic and legal issues is highly desirable. The Commission has approved many settlements. The use of this procedure may well

be explored further in an effort to obtain a true "balancing of the investor and the consumer interests."[61]

One point remains to be mentioned. Eleven motions for leave to adduce additional evidence were filed with us by various producers. We deferred all to the hearing on the merits. In view of the disposition which we make of the cases we see no reasons to explore evidentiary problems which may arise on remand. The Commission will hold such additional hearings as are needed to determine the effect of the quality adjustments, and to determine the group revenues and the group revenue requirements. It will make appropriate findings on these matters. The order based thereon shall contain an adequate provision for special exemptions. We decline to make advance rulings on the procedures to be followed or on the evidence to be received.

The motions to adduce additional evidence are severally denied. The petitions to review are severally granted and the cases are all remanded to the Commission for further proceedings consistent with this opinion.

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[61] 320 U.S. 591, 603.

APPENDIX B

Rates And Charges; Schedules; Suspension Of New Rates

Sec. 4. (a) All rates and charges made, demanded, or received by any natural-gas company for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges, shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful.

(b) No natural-gas company shall, with respect to any transportation or sale of natural gas subject to the jurisdiction of the Commission, (1) make or grant any undue preference or advantage to any person or subject any person to any undue prejudice or disadvantage, or (2) maintain any unreasonable difference in rates, charges, service, facilities, or in any other respect, either as between localities or as between classes of service.

(c) Under such rules and regulations as the Commission may prescribe, every natural-gas company shall file with the Commission, within such time (not less than sixty days from the date this act takes effect) and in such form as the Commission may designate, and shall keep open in convenient form and place for public inspection, schedules showing all rates and charges for any transportation or sale subject to the jurisdiction of the Commission, and the classifications, practices, and regulations affecting such rates and charges, together with all contracts which in any manner affect or relate to such rates, charges, classifications, and services.

(d) Unless the Commission otherwise orders, no change shall be made by any natural-gas company in any such rate, charge, classification, or service, or in any rule, regulations, or contract relating thereto, except after thirty days' notice to the Commission and to the public. Such notice shall be given by filing with the Commission and keeping open for public inspection new schedules stating plainly the change or changes to be made in the schedule or schedules then in force and the time when the change or changes will go into effect. The Commission, for good cause shown, may allow changes to take effect without requiring the thirty days' notice herein provided for by an order specifying the changes so to be made and the time when they shall take effect and the manner in which they shall be filed and published.

(e) Whenever any such new schedule is filed the Commission shall have authority, either upon complaint of any State, municipality, State commission, or gas distributing company or upon its own initiative without complaint, at once, and if it so orders, without answer or formal pleading by the natural-gas company, but upon reasonable notice, to enter upon a hearing concerning the lawfulness of such rate, charge, classification, or service; and, pending such hearing and the decision thereon, the Commission, upon filing with such schedules and delivering to the natural-gas company affected thereby a statement in writing of its reasons for such suspension, may suspend the operation of such schedule and defer the use of such rate, charge, classification, or service, but not for a longer period than five months beyond the time when it would otherwise go into

effect; and after full hearings either completed before or after the rate, charge, classification, or service goes into effect, the Commission may make such orders with reference thereto as would be proper in a proceeding initiated after it had become effective. If the proceeding has not been concluded and an order made at the expiration of the suspension period, on motion of the natural-gas company making the filing, the proposed change of rate, charge, classification, or service shall go into effect. Where increased rates or charges are thus made effective, the Commission may, by order, require the natural-gas company to furnish a bond, to be approved by the Commission, to refund any amounts ordered by the Commission, to keep accurate accounts in detail of all amounts received by reason of such increase, specifying by whom and in whose behalf such amounts were paid, and, upon completion of the hearing and decision, to order such natural-gas company to refund, with interest, the portion of such increased rates or charges by its decision found not justified. At any hearing involving a rate or charge sought to be increased, the burden of proof to show that the increased rate or charge is just and reasonable shall be upon the natural-gas company, and the Commission shall give to the hearing and decision of such questions preference over other questions pending before it and decide the same as speedily as possible. [52 Stat. 822 (1938); 76 Stat. 72 (1962); 15 U.S.C. § 717c]

Fixing Rate And Charges; Determination Of Cost Of Production Or Transportation

SEC. 5. (a) Whenever the Commission, after a hearing had upon its own motion or upon complaint of any

State, municipality, State commission, or gas distributing company, shall find that any rate, charge, or classification demanded, observed, charged, or collected by any natural-gas company in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order: *Provided, however,* That the Commission shall have no power to order any increase in any rate contained in the currently effective schedule of such natural-gas company on file with the Commission, unless such increase is in accordance with a new schedule filed by such natural-gas company; but the Commission may order a decrease where existing rates are unjust, unduly discriminatory, preferential, otherwise unlawful, or are not the lowest reasonable rates.

(b) The Commission upon its own motion, or upon the request of any State commission, whenever it can do so without prejudice to the efficient and proper conduct of its affairs, may investigate and determine the cost of the production or transportation of natural gas by a natural-gas company in cases where the Commission has no authority to establish a rate governing the transportation or sale of such natural gas. [52 Stat. 823 (1938); 15 U.S.C. § 717d]

Administration Powers of Commission; Rules, Regulations, and Orders

Sec. 16. The Commission shall have power to perform any and all acts, and to prescribe, issue, make, amend, and rescind such orders, rules and regulations as it may find necessary or appropriate to carry out the provisions of this act. Among other things, such rules and regulations may define accounting, technical, and trade terms used in this act; and may prescribe the form or forms of all statements, declarations, applications, and reports to be filed with the Commission, the information which they shall contain, and the time within which they shall be filed. Unless a different date is specified therein, rules and regulations of the Commission shall be effective thirty days after publication in the manner which the Commission shall prescribe. Orders of the Commission shall be effective on the date and in the manner which the Commission shall prescribe. For the purposes of its rules and regulations, the Commission may classify persons and matters within its jurisdiction and prescribe different requirements for different classes of persons or matters. All rules and regulations of the Commission shall be filed with its secretary and shall be kept open in convenient form for public inspection and examination during reasonable business hours. [52 Stat. 830 (1938); 15 U.S.C. § 717o]

Rehearing; Court Review Of Orders

Sec. 19. (a) Any person, State, municipality, or State commission aggrieved by an order issued by the Commission in a proceeding under this act to which such

person, State, municipality, or State commission is a party may apply for a rehearing within thirty days after the issuance of such order. The application for rehearing shall set forth specifically the ground or grounds upon which such application is based. Upon such application the Commission shall have power to grant or deny rehearing or to abrogate or modify its order without further hearing. Unless the Commission acts upon the application for rehearing within thirty days after it is filed, such application may be deemed to have been denied. No proceeding to review any order of the Commission shall be brought by any person unless such person shall have made application to the Commission for a rehearing thereon. Until the record in a proceeding shall have been filed in a court of appeals, as provided in subsection (b), the Commission may at any time, upon reasonable notice and in such manner as it shall deem proper, modify or set aside, in whole or in part, any finding or order made or issued by it under the provisions of this Act.

(b) Any party to a proceeding under this act aggrieved by an order issued by the Commission in such proceeding may obtain a review of such order in the circuit court of appeals of the United States for any circuit wherein the natural-gas company to which the order relates is located or has its principal place of business, or in the United States Court of Appeals for the District of Columbia, by filing in such court, within sixty days after the order of the Commission upon the application for rehearing, a written petition praying that the order of the Commission be modified or set aside in whole or in part. A copy of such petition shall

forthwith be transmitted by the clerk of the court to any member of the Commission and thereupon the Commission shall file with the court the record upon which the order complained of was entered, as provided in section 2112 of title 28, United States Code. Upon the filing of such petition such court shall have jurisdiction, which upon the filing of the record with it shall be exclusive, to affirm, modify, or set aside such order in whole or in part. No objection to the order of the Commission shall be considered by the court unless such objection shall have been urged before the Commission in the application for rehearing unless there is reasonable ground for failure so to do. The finding of the Commission as to the facts, if supported by substantial evidence, shall be conclusive. If any party shall apply to the court for leave to adduce additional evidence, and shall show to the satisfaction of the court that such additional evidence is material and that there were reasonable grounds for failure to adduce such evidence in the proceedings before the Commission, the court may order such additional evidence to be taken before the Commission and to be adduced upon the hearing in such manner and upon such terms and conditions as to the court may seem proper. The Commission may modify its findings as to the facts by reason of the additional evidence so taken, and it shall file with the court such modified or new findings, which if supported by substantial evidence, shall be conclusive, and its recommendation, if any, for the modification or setting aside of the original order. The judgment and decree of the court, affirming, modifying, or setting aside, in whole or in part, any such order of the Commission, shall be final, subject to review by the Supreme Court of

the United States upon certiorari or certification as provided in [former] sections 239 and 240 of the Judicial Code, as amended (U.S.C., title 28, sec. 1254).

(c) The filing of an application for rehearing under subsection (a) shall not, unless specifically ordered by the Commission, operate as a stay of the Commission's order. The commencement of proceedings under subsection (b) of this section shall not, unless specifically ordered by the court, operate as a stay of the Commission's order. [52 Stat. 831 (1938); 15 U.S.C. § 717r]

MOTION TO PETITION FOR A WRIT OF CERTIORARI

IN THE

Supreme Court of the United States

OCTOBER TERM, 1966

No. ~~1295~~

PACIFIC GAS AND ELECTRIC COMPANY,
PACIFIC LIGHTING SERVICE AND SUPPLY COMPANY,
SAN DIEGO GAS & ELECTRIC COMPANY,
SOUTHERN CALIFORNIA GAS COMPANY AND
SOUTHERN COUNTIES GAS COMPANY OF CALIFORNIA,

Petitioners,

v.

SKELLY OIL COMPANY, ET AL.,

Respondents.

MOTION FOR LEAVE TO FILE SUPPLEMENT TO PETITION FOR CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT AND SUPPLEMENT TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1966

No. 1295

PACIFIC GAS AND ELECTRIC COMPANY,
PACIFIC LIGHTING SERVICE AND SUPPLY COMPANY,
SAN DIEGO GAS & ELECTRIC COMPANY,
SOUTHERN CALIFORNIA GAS COMPANY AND
SOUTHERN COUNTIES GAS COMPANY OF CALIFORNIA,
Petitioners,

v.

SKELLY OIL COMPANY, ET AL.,
Respondents.

MOTION FOR LEAVE TO FILE SUPPLEMENT TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

Petitioners, Pacific Gas and Electric Company, Pacific Lighting Service and Supply Company, San Diego Gas & Electric Company, Southern California Gas Company, and Southern Counties Gas Company of California, pursuant to Rule 35 of the Revised Rules of this Court, respectfully move for leave to file a supplement to their Petition for a Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit, which was filed with this Court on April 19, 1967.

The Petition for a Writ of Certiorari previously filed by Petitioners raised certain questions with respect to the

Court of Appeals' opinion in *Skelly Oil Co. v. F.P.C.*, ... F.2d ..... (10th Cir., 1967). The opinion and judgment of that court was issued on January 20, 1967, and the last date to file petitions for certiorari was, therefore, April 20, 1967. Petitioners, therefore, timely filed for their Petition for a Writ of Certiorari.

Between March 6 and March 10, 1967, a number of natural gas producer respondents[1] to the Commission's opinion below petitioned the Court of Appeals for rehearing on a limited number of issues. On April 18, 1967, the Court of Appeals issued an opinion on rehearing which now raises two additional questions of great significance. This opinion was issued after Petitioners had printed their Petition for a Writ of Certiorari and Petitioners were, therefore, unable to include these new vital matters in their petition filed on April 19, 1967.

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[1] Pan American Petroleum Corporation and Sinclair Oil & Gas Company; Texaco Inc., Amerada Petroleum Corporation, Atlantic Richfield Company, Southland Royalty Company, Westates Petroleum Company, Dorchester Gas Producing Company, Sunray DX Oil Company, Marathon Oil Company, Sohio Petroleum Company, and Tidewater Oil Company; Mobil Oil Corporation and Northern Natural Gas Producing Company; Standard Oil Company of Texas, a Division of Chevron Oil Company; Shell Oil Company and Phillips Petroleum Company; Warren Petroleum Corporation, Gulf Oil Corporation, The British-American Oil Producing Company, Humble Oil & Refining Company, Cities Service Oil Company, Cities Service Production Company, Coltexo Corporation, Columbian Fuel Corporation, and Columbian Carbon Company.

WHEREFORE, Petitioners pray that they be allowed to supplement their previously filed Petition for Writ of Certiorari with the Supplement to Writ of Certiorari attached hereto.

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by /s/ JOHN ORMASA
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In their petitions for rehearing to the Court of Appeals, certain respondent producers[1] raised, along with others, two issues, one which the Court of Appeals had apparently overlooked and another on which it had sustained the Commission.

On April 18, 1967, in response to said petitions for rehearing the Court of Appeals issued an opinion on these two issues.[2]

The additional questions presented *infra* which we seek to have reviewed by this Supplement to our Petition for Certiorari encompass these two issues.

CITATIONS TO ADDITIONAL OPINIONS BELOW

The opinion of the Court of Appeals on rehearing is as yet unreported and is printed in Appendix A hereto, beginning at page 10.

ADDITIONAL QUESTIONS PRESENTED

1. Can the Federal Power Commission in a Natural Gas Act Section 7 (15 U.S.C. § 717f) initial certificate proceeding involving producer rates adopt as the in-line rate its most recently determined applicable just and reasonable area rate?

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[1] These parties are noted in the footnote appearing at page 2.

[2] The judgments issued by the Court of Appeals in all of the petitions for review were in the same form. The one contained in Superior Oil Company's Petition for Writ of Certiorari (No. 1287) is typical. No new judgments were issued following the opinion on rehearing.

2. Can the Commission in an area rate order require individual producers to refund rates in effect subject to refund to the extent that they exceed the applicable area rate?

ADDITIONAL STATUTE INVOLVED

The additional statutory provision involved is Section 7 of the Natural Gas Act (15 U.S.C. § 717f). It is printed in Appendix B hereto, beginning at page 12.

ADDITIONAL REASONS FOR GRANTING THE WRIT

1. The Federal Power Commission Should Be Required to Apply as an In-Line Rate a Rate Recently Determined to Be the Just and Reasonable Rate.

The court below in its opinion on rehearing refused to decide whether an area rate established after extensive hearings automatically becomes the in-line rate in a Natural Gas Act Section 7 (15 U.S.C. § 717f) proceeding because it rejected the area rate. A decision on this issue is essential to the orderly administration of producer regulation under the Natural Gas Act.

If the Commission is unable to apply the area rate determined in proceedings under Sections 4 (15 U.S.C. §717c) and 5 (15 U.S.C. § 717d) of the Natural Gas Act as the rate for new sales authorized under Section 7, the painstaking and timely effort involved in area rate-making will have little prospective application to new supplies sold in interstate commerce. By not applying the area rate as the in-line rate, Section 7 proceedings would become a sieve through which excessive prices will be

certificated for new gas until another area rate proceeding is determined. Common sense itself dictates any rate in excess of the area rate is "suspect" and therefore an invalid basis for an in-line determination. The only nonsuspect price is the area rate and it must therefore be the in-line price. It is, therefore, imperative and appropriate that the area rate determined in a Section 4 and Section 5 proceeding be used as the in-line rate for a reasonable period of time thereafter if the consumer is to be afforded needed protection under the Natural Gas Act. (*Atlantic Ref. Co. v. Pub. Serv. Com. of New York*, 360 U.S. 378 (1959).)

2. The Only Appropriate Refund Method is a Company-By-Company and Rate Schedule-By-Rate Schedule Method.

On rehearing the Court of Appeals reversed itself on the issue of the computation of refunds. In its prior opinion, the court below agreed with the Commission that refunds should be ordered on a company-by-company and rate schedule-by-rate schedule basis. In doing so, it stated:

> "We see no escape from the requirement that refunds be on a company-by-company basis and on a schedule-by-schedule basis."[3]

It now states, however, on rehearing that:

> "This modification of the opinion means that no refund obligation may be imposed for a period in which there is a group revenue deficiency. When group revenues exceed group revenue requirements,

[3] Appendices to Petition for Writ of Certiorari pp. 426-427.

refunds may be ordered on some equitable contract-by-contract basis. In fixing an area rate, the Commission must consider the effect which past and potential refunds have on the balancing of group revenues with group revenue requirements."[4]

The examiner fell into the same error in his decision. The Commission corrected the error with the following comment:

> "Several fundamental objections preclude adoption of the examiner's proposed method of computing refunds. We think it would result in inequities among wholesale customers as well as among individual producers. If one wholesale customer has been overcharged it is of little comfort to him to know that another customer has received a bargain. Conversely, if one producer has collected excessive amounts, he should not be relieved of his responsibility to return the excess by reason of the fact that some other producer collected too little. Furthermore, the administrative difficulties involved in attempting for each year, and each category of sales, to equate industry revenues with industry expenditures, and to allocate the excess revenues among the purchasers, seem almost insurmountable." (Opinion No. 468, 34 FPC 159, 232-234 (1965), JA 277, 689)

The Commission's refund order based on its sound administrative expertise, as evidenced by the above quotation, produces a fair and just result to consumer

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[4] Appendix A p. 12, *infra.*

and producer alike and conforms to the very purpose of the Natural Gas Act.

CONCLUSION

In order to correct all the errors made by the Court of Appeals in its decision, it is necessary to review the two new issues raised by the Court of Appeals' opinion on rehearing. We, therefore, respectfully urge this Court to grant our previously filed Petition for a Writ of Certiorari as augmented by this Supplement.

Respectfully presented,

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APPENDIX

APPENDIX A

United States Court of Appeals
TENTH CIRCUIT

Nos. 8385 etc., MARCH TERM, 1967

SKELLY OIL COMPANY, et al.,
Petitioners,
v.
FEDERAL POWER COMMISSION,
Respondent.

FILED
UNITED STATES
COURT OF APPEALS
TENTH CIRCUIT
APR 18, 1967
WILLIAM L. WHITTAKER
CLERK

ON REHEARING.
PER CURIAM.

Texaco Inc. asserts that the opinion is not clear as to the disposition of its Docket No. C161-879 in which, by an order separate and apart from Opinions Nos. 468 and 468-A and their accompanying orders, a § 7 certificate was issued at a rate of 14.5 cents less quality deductions. This separate order shows that the Commission treated the area rate as the in-line rate for § 7 certificates.

The order on this docket was lost in the mass of material presented to us. No party made a point of it. We have reconsidered the Texaco petition for review and have concluded that it is sufficiently broad to cover such order. It should receive the same treatment as the § 4 and § 5 proceedings. Accordingly, the remand in-

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cludes the separate order entered in Docket No. C161-879.

We note that in its disposition of this particular docket the Commission took the position that an established area rate automatically becomes the in-line rate for a § 7 proceeding. The same position was taken by the Commission in its Opinion No. 484 which we are today reversing by our decision in Nos. 8723 etc. — Phillips Petroleum Company, et al., v. Federal Power Commission, ... F.2d ..... We there hold that in a § 7 application heard by the Commission after its Permian decision the adoption of the area rate as an in-line rate must fall because we have rejected the area rate. We do not there, and we do not here, express either approval or disapproval of the principle that an area rate established in a § 5 proceeding automatically becomes an in-line rate for a § 7 proceeding. The validity of such a principle may be affected by the final determination of the validity of the Permian Basin area rate.

Various producers insist that we erred in our treatment of refunds. We held that refunds must be on a company-by-company and schedule-by-schedule basis. We are now convinced that such holding was wrong and is inconsistent with our conclusion that satisfaction of the end result test requires rates which will equate group revenues with group revenue requirements.

The refunds in question relate to collections made during the so-called "locked-in" periods, i.e., the periods during which an increased rate, later superseded by a further increase, is effective. See Second Phillips, 373 U.S. 294, 298, fn. 5. In that case the Court said that

on the locked-in rate issue "the sole question was whether all or any part of the increases had to be refunded by Phillips." The Court pointed out that the Commission decided that the increases did not bring revenues up to cost of service, and held that the Commission "properly concluded" that "no refund obligations could be imposed." *Id.* at 306.

We are now convinced that this treatment of refund obligations for locked-in rates in the case of an individual company in Second Phillips must be applied on a group basis when an area rate is fixed and tested by the end result. We are also convinced that our reliance on Federal Power Commission v. Tennessee Gas Transmission Co., 371 U.S. 145, was misplaced. That case dealt with zone rates. The Second Phillips decision on locked-in rates came later.

This modification of the opinion means that no refund obligation may be imposed for a period in which there is a group revenue deficiency. When group revenues exceed group revenue requirements, refunds may be ordered on some equitable contract-by-contract basis. In fixing an area rate, the Commission must consider the effect which past and potential refunds have on the balancing of group revenues with group revenue requirements.

In all respects, except those specifically noted herein, the petitions for rehearing are severally denied.

APPENDIX

APPENDIX B

NATURAL GAS ACT
EXTENSION OF FACILITIES; ABANDONMENT OF SERVICE

Sec. 7. (a) Whenever the Commission, after notice and opportunity for hearing, finds such action necessary or desirable in the public interest, it may by order direct a natural-gas company to extend or improve its transportation facilities, to establish physical connection of its transportation facilities with the facilities of, and sell natural gas to, any person or municipality engaged or legally authorized to engage in the local distribution of natural or artificial gas to the public, and for such purpose to extend its transportation facilities to communities immediately adjacent to such facilities or to territory served by such natural-gas company, if the Commission finds that no undue burden will be placed upon such natural-gas company thereby: *Provided,* That the Commission shall have no authority to compel the enlargement of transportation facilities for such purposes, or to compel such natural-gas company to establish physical connection or sell natural gas when to do so would impair its ability to render adequate service to its customers. [52 Stat. 824 (1938); 15 U.S.C. §717f (a)]

(b) No natural-gas company shall abandon all or any portion of its facilities subject to the jurisdiction of the Commission, or any service rendered by means of such facilities, without the permission and approval of the Commission first had and obtained, after due hearing, and a finding by the Commission that the available supply of natural gas is depleted to the extent that the con-

tinuance of service is unwarranted, or that the present or future public convenience or necessity permit such abandonment. [52 Stat. 824 (1938); 15 U.S.C. §717f (b)]

(c) No natural-gas company or person which will be a natural-gas company upon completion of any proposed construction or extension shall engage in the transportation or sale of natural gas, subject to the jurisdiction of the Commission, or undertake the construction or extension of any facilities therefor, or acquire or operate any such facilities or extensions thereof, unless there is in force with respect to such natural-gas company a certificate of public convenience and necessity issued by the Commission authorizing such acts or operations: *Provided, however,* That if any such natural-gas company or predecessor in interest was bona fide engaged in transportation or sale of natural gas, subject to the jurisdiction of the Commission, on the effective date of this amendatory Act, over the route or routes or within the area for which application is made and has so operated since that time, the Commission shall issue such certificate without requiring further proof that public convenience and necessity will be served by such operation, and without further proceedings, if application for such certificate is made to the Commission within ninety days after the effective date of this amendatory Act. Pending the determination of any such application, the continuance of such operation shall be lawful.

In all other cases the Commission shall set the matter for hearing and shall give such reasonable notice of the hearing thereon to all interested persons as in its judgment may be necessary under rules and regulations

to be prescribed by the Commission; and the application shall be decided in accordance with the procedure provided in subsection (e) of this section and such certificate shall be issued or denied accordingly: *Provided, however,* That the Commission may issue a temporary certificate in cases of emergency, to assure maintenance of adequate service or to serve particular customers, without notice or hearing, pending the determination of an application for a certificate, and may by regulation exempt from the requirements of this section temporary acts or operations for which the issuance of a certificate will not be required in the public interest. [52 Stat. 825 (1938), as amended, 56 Stat. 83 (1942); 15 U.S.C. § 717f (c)]

(d) Application for certificates shall be made in writing to the Commission, be verified under oath, and shall be in such form, contain such information, and notice thereof shall be served upon such interested parties and in such manner as the Commission shall, by regulation, require. [56 Stat. 84 (1942); 15 U.S.C. § 717f (d)]

(e) Except in the cases governed by the provisos contained in subsection (c) of this section, a certificate shall be issued to any qualified applicant therefor, authorizing the whole or any part of the operation, sale, service, construction, extension, or acquisition covered by the application, if it is found that the applicant is able and willing properly to do the acts and to perform the service proposed and to conform to the provisions of the Act and the requirements, rules, and regulations of the Commission thereunder, and that the proposed service, sale, operation, construction, extension, or acquisition, to the extent authorized by the certificate, is or will be required

by the present or future public convenience and necessity; otherwise such application shall be denied. The Commission shall have the power to attach to the issuance of the certificate and to the exercise of the rights granted thereunder such reasonable terms and conditions as the public convenience and necessity may require. [56 Stat. 84 (1942); 15 U.S.C. § 717f (e)]

(f) The Commission, after a hearing had upon its own motion or upon application, may determine the service area to which each authorization under this section is to be limited. Within such service area as determined by the Commission a natural-gas company may enlarge or extend its facilities for the purpose of supplying increased market demands in such service area without further authorization. [56 Stat. 84 (1942); 15 U.S.C. § 717f(f)]

(g) Nothing contained in this section shall be construed as a limitation upon the power of the Commission to grant certificates of public convenience and necessity for service of an area already being served by another natural-gas company. [56 Stat. 84 (1942); 15 U.S.C. § 717f(g)]

(h) When any holder of a certificate of public convenience and necessity cannot acquire by contract, or is unable to agree with the owner of property to the compensation to be paid for, the necessary right-of-way to construct, operate, and maintain a pipe line or pipe lines for the transportation of natural gas, and the necessary land or other property, in addition to right-of-way, for the location of compressor stations, pressure apparatus, or other stations or equipment necessary to the proper

operation of such pipe line or pipe lines, it may acquire the same by the exercise of the right of eminent domain in the district court of the United States for the district in which such property may be located, or in the State courts. The practice and procedure in any action or proceeding for that purpose in the district court of the United States shall conform as nearly as may be with the practice and procedure in similar action or proceeding in the courts of the State where the property is situated: *Provided*, That the United States district courts shall only have jurisdiction of cases when the amount claimed by the owner of the property to be condemned exceeds $3,000. [61 Stat. 459 (1947); 15 U. S. C. § 717f(h)]

PETITION FOR A WRIT OF CERTIORARI

FILED
APR 20 1967
JOHN F. DAVIS, CLERK

IN THE

Supreme Court of the United States

October Term, 1966 67

No. ~~1302~~ 105

PERRY R. BASS, PANTHER CITY INVESTMENT CO.,
BASS BROS. ENTERPRISES, INC.,
PERRY R. BASS, INCORPORATED, AND
RICHARDSON OILS, INC.,

Petitioners,

v.

FEDERAL POWER COMMISSION,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

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April 18, 1967

FIDELITY PRINTING COMPANY, INC., HOUSTON

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IN THE

Supreme Court of the United States

October Term, 1966

No. .....

PERRY R. BASS, PANTHER CITY INVESTMENT CO.,
BASS BROS. ENTERPRISES, INC.,
PERRY R. BASS, INCORPORATED, AND
RICHARDSON OILS, INC.,

Petitioners,

v.

FEDERAL POWER COMMISSION,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

Petitioners, Perry R. Bass, Panther City Investment Co., Bass Bros. Enterprises, Inc., Perry R. Bass, Incorporated, and Richardson Oils, Inc., pray that a Writ of Certiorari issue to review the judgment of the United States Court of Appeals for the Tenth Circuit in this case entered on January 20, 1967.

OPINION BELOW

The opinion of the Court of Appeals for the Tenth Circuit in *Skelly Oil Company* v. *Federal Power Commission*

is not yet officially reported.[1] The orders of the Federal Power Commission are reported at 34 FPC 159, 1068, 1082 and 1198.

JURISDICTION

The judgment of the Court of Appeals was entered January 20, 1967. Jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1) and section 19(b) of the Natural Gas Act, 15 U.S.C. § 717r(b).

STATUTE INVOLVED

The Natural Gas Act, June 21, 1938 c. 556, 52 Stat. 821-833, as amended, 15 U.S.C. § 717-717w, provides in pertinent part as follows:

Section 5(a), 15 U.S.C. § 717d(a):

> Whenever the Commission, after a hearing, * * * shall find that any rate, charge, or classification demanded, observed, charged, or collected by any natural-gas company in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order: * * *

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[1] Printed copies of this opinion will be submitted with the petitions for certiorari which Petitioners understand are concurrently being filed by the Federal Power Commission and other parties to the proceedings in the court below. Accordingly, Petitioners have not included said opinion as an appendix to this petition.

QUESTIONS PRESENTED

1. Whether, in reviewing prices charged by natural gas producers under section 5(a) of the Natural Gas Act, the Commission may determine that a permanently certificated price is unjust or unreasonable without considering proffered evidence of, or making allowance for, (1) special services rendered in connection with a particular sale and (2) the revenue requirements of the individual producers involved.

2. Whether, in determining just and reasonable area prices under section 5(a) of the Natural Gas Act, the Commission erred in failing to include an allowance for gathering and processing costs actually incurred by producers.

3. Whether, in determining just and reasonable area prices, the Commission erred in failing to give the parties notice that quality standards were at issue and that the area prices established would be reduced by an undetermined amount for gas which did not meet such quality standards.

4. Whether, in relying solely upon its determination of the average cost of *gas-well gas,* produced by a group of major companies in the Permian Basin area of West Texas and New Mexico during the year 1960, the Federal Power Commission sustained its burden of proof under section 5(a) of the Natural Gas Act of showing by substantial evidence and soundly based findings that Petitioners' permanently certificated 18¢ per Mcf price for sales of *residue gas* was unjust or unreasonable and that the just and reasonable price for such sales for 1966 and future years was 14.5¢ per Mcf less an undetermined reduction for gas which did not meet quality standards prescribed by the Commission.

STATEMENT OF THE CASE

In its first *Phillips* decision,[2] this Court directed the Commission to regulate the prices charged by natural gas producers making sales in interstate commerce. Subsequently, Petitioners sought Commission certification of a proposed sale of residue gas to Transwestern Pipeline Company under contract dated July 9, 1958. Because of the many premium services (including extensive gathering, processing and compression) offered by Petitioners, the Commission certificated this sale at a price of 18¢ per Mcf[3] (22 F.P.C. 39). In supplemental proceedings, the Commission again determined (28 F.P.C. 109) that the public interest price for this sale to Transwestern was 18¢ per Mcf. This price was 2¢ above the 16¢ per Mcf price that the Commission had adopted as the area guideline price (24 F.P.C. 818).

In its second *Phillips* decision,[4] this Court sustained the Commission's determination to regulate producer prices on an area basis. However, the Court made it clear that it was not passing upon the lawfulness of the Commission's implementation of area pricing:

> "The lawfulness of the area pricing methods are not themselves before the court for review." 373 U.S. at 308.

The Commission's first attempt at implementing area prices was directed to the Permian Basin area of West Texas and New Mexico. In the orders under review the Commission established two just and reasonable ceiling prices for inter-

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[2] *Phillips Petroleum Co.* v. *Wisconsin,* 347 U.S. 672 (1954).

[3] The Commission concurrently certificated other sales of gas to Transwestern at 16¢ per Mcf, thus recognizing the 2¢ per Mcf additional value of the premium services to be performed by Petitioners.

[4] *Wisconsin* v. *FPC,* 373 U.S. 294 (1963).

state sales of gas from this area. It found all prices in excess of such ceiling to be unjust and unreasonable and ordered that any higher prices be reduced to the applicable ceiling effective September 1, 1965. The Commission set a ceiling price of 16.5¢ per Mcf for gas-well gas (and residue gas derived therefrom) sold under contracts executed on or after January 1, 1961; as to all other sales of gas the Commission set a ceiling price of 14.5¢ per Mcf. These ceiling prices were based upon the Commission's determinations of the average cost of gas-well gas on an area and nationwide basis produced by a group of major producers during the year 1960. The allowance for gathering or processing costs actually incurred by Petitioners and other producers was not included in such composite cost determinations. Without notice,[5] the Commission simultaneously determined quality standards and provided that its ceiling prices should be reduced by an undetermined amount if gas did not meet such quality standards.

On the basis of its composite average area cost determination, the Commission found that Petitioners' 18¢ price for *residue gas* sold to Transwestern was unjust and unreasonable and that the just and reasonable price for such sale for 1966 and future years was 14.5¢ per Mcf less the undetermined quality deduction. As a result, Petitioners sustained the largest single reduction of any permanently certificated price in the Permian Basin area. The Commission refused to consider evidence of the unique premium services rendered by Petitioners despite the fact that on two previous occasions the existence of these unique fea-

[5] During the hearings the Commission denied a producer motion requesting that a pending rule-making proceeding involving the establishment of quality standards be consolidated with this area-rate proceeding. When the Commission denied this motion, efforts to present evidence on the issue of quality standards were abandoned by the producers and eventually by the staff of the Commission.

tures had prompted the Commission to certificate Petitioners' sales at prices that were 2¢ per Mcf higher than the area guideline price. It also rejected evidence offered to show that an 18¢ price was just and reasonable in light of Petitioners' revenue requirements.

Petitioners and other producers sought review of the Commissioner's orders in the United States Court of Appeals for the Tenth Circuit.[6] On January 20, 1967, that court reversed and remanded the Commission's orders for further proceedings because "the actions of the Commission do not comply with the end result test established in *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591, 602-603, and other decisions."[7] However, the court either impliedly or expressly denied Petitioners' points of error relating to each of the questions presented herein.

STATEMENT OF POSITION AND CONDITIONS FOR GRANTING THE WRIT

1.

Petitioners believe that all petitions for writs of certiorari in this case should be denied and that further proceedings should be held by the Federal Power Commission consistent with the opinion of the court below. The Tenth Circuit sustained the Commission's power to determine just and reasonable rates pursuant to sections 4 and 5 of the Natural Gas Act on a group or area basis rather than on an individual producer basis. The court also rejected many

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[6] Petitioners' appeal was docketed as No. 8511 in the Court of Appeals.

[7] In *Colorado Interstate Gas Co.* v. *FPC*, 324 U.S. 581, 605 (1945), this Court stated:

> "In those cases we held that the question for the courts when a rate order is challenged is whether the order viewed in its entirety and measured by its end results meets the requirements of the Act."

of the other attacks made on the Commissioner's area rate determination, including those raised herein by Petitioners. However, the court held that the case should be remanded because the Commission failed to determine the financial impact of the quality deductions and thereby made it impossible to determine "whether the proper revenue requirements of the area producers as a group can be satisfied with rates having the ceiling and floor which the Commission fixed."[8] The court also held that the provisions in the Commission's orders for special relief from the area rates was insufficient and unsatisfactory. Accordingly, the court below directed the Commission "to hold such additional hearings as are needed to determine the effect of the quality adjustments, and to determine the group revenues and group revenue requirements," to make findings thereon, and to issue an order containing an adequate provision for special relief.

When these subsequent determinations are made by the Commission, many of the questions now raised by Petitioners and other may no longer exist.[9] On the other hand, should the Commission's decision again adversely affect any party, he will still be in a position to challenge the Commission's area rate determinations, including the power

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[8] The court below deferred passing on the producers' contention that the quality standards prescribed by the Commission violated procedural due process because of lack of notice. The court assumed that this defect, if there was one, would be cured by the remanded proceedings where everyone would have notice. It also requested the Commission to clarify the reasons for its price adjustment based on the BTU content of the gas.

[9] For example, as suggested by the court below, the special relief clause may provide producers with an allowance for actual costs incurred in connection with furnishing gathering facilities. Also, the argument that the imposition of quality standards violates procedural due process because of lack of notice will be rendered moot.

of the Commission to set area rates.[10] In any event, when the Commission has determined the jurisdictional revenues which its area rates will produce and made the other findings required by the court below, this Court will be able to appraise more realistically and intelligently the validity of the Commission's area rate determinations.

2.

The importance of this case to the administration of the Natural Gas Act is self-evident. It is the logical sequel to this Court's first and second *Phillips* decisions.[11] Having determined that the Federal Power Commission must regulate prices charged by producers for interstate sales of natural gas and that regulation on an area basis can be lawful, this Court is now requested to pass upon the lawfulness of the Commission's initial attempt to set area rates.

As stated above, Petitioners believe that there is no occasion for the Court to review this case at the present stage of the proceedings. However, should the Court grant certiorari in response to the petitions filed by the Federal Power Commission or any of the other parties, Petitioners submit that the points of error and arguments of all parties with respect to the opinion of the court below should be before the Court for simultaneous review. The case below involved many complex questions. Review of only a few of these questions would be incomplete and would not permit this Court to decide adequately the basic questions relating to area pricing methods. In this connection, Petitioners point out that in the court below they were the principal

[10] *Hamilton-Brown Shoe Co.* v. *Wolf Brothers & Co.*, 240 U.S. 251, 257-58 (1916); see also *Urie* v. *Thompson*, 337 U.S. 163, 172-73 (1949); *United States* v. *United States Smelting Refining & Mining Co.*, 339 U.S. 186, 198-99 (1950); Stern and Gressman, *Supreme Court Practice* § 2-2 (3d ed. 1962).

[11] Footnotes 2 and 4, *supra*.

proponents of the questions presented herein. Although these questions are predicated upon facts related to Petitioners' sales of residue gas, they have general applicability to other similarly situated producers in the Permian Basin area. Therefore, the granting of this petition will bring before the Court questions which are of vital importance to the establishment of just and reasonable area prices by the Commission.

CONCLUSION

For the foregoing reasons, this Petition for Writ of Certiorari should be granted in the event the Court determines to grant other concurrently filed petitions.

Respectfully submitted,

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April 18, 1967

PETITION FOR A WRIT OF CERTIORARI

MAY 1 19
JOHN F. DAVIS, CLE

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No. ~~1242~~

In the Supreme Court of the United States

OCTOBER TERM, 1966

FEDERAL POWER COMMISSION, PETITIONER

v.

SKELLY OIL COMPANY, ET AL.

("Permian Basin Area Rate Case")

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

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In the Supreme Court of the United States

OCTOBER TERM, 1966

No.

FEDERAL POWER COMMISSION, PETITIONER

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("Permian Basin Area Rate Case")

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

The Solicitor General, on behalf of the Federal Power Commission, petitions for a writ of certiorari to review the judgments of the United States Court of Appeals for the Tenth Circuit, entered in this case on January 20, 1967.

OPINIONS BELOW

The opinion of the court of appeals (Cal. Pet. App. 382–431)[1] and its opinion on rehearing (App. B, *infra*, pp. 44–46) are not yet reported. The opinions and orders of the Federal Power Commission (J.A. 516d–826d, 827d–838d, 37s, 1105d–1132d, and 1133d–1136d;[2]

[1] "Cal. Pet. App." refers to the separate appendix filed in this Court by the State of California with its petition (No. 1293).

[2] The Joint Appendix in the court of appeals consists of thirteen volumes paginated as follows: Volumes I–V, which

Cal. Pet. App. 1–381) are reported at 34 F.P.C. 159, 418, 424, 1068, and 1082. The opinion of the hearing examiner (J.A. 97d–364d) is reported at 34 F.P.C. 306.

JURISDICTION

The judgments of the court of appeals were entered on January 20, 1967 (App. A, *infra,* pp. 25–43), and were modified by an order on rehearing entered on April 18, 1967 (App. B, *infra,* pp. 44–46). On April 18, 1967, Mr. Justice White extended the time for filing a petition for a writ of certiorari on behalf of the Federal Power Commission to June 19, 1967. We invoke the jurisdiction of this Court under 28 U.S.C. 1254(1) and Section 19(b) of the Natural Gas Act, 15 U.S.C. 717r(b).

STATUTES INVOLVED

The pertinent provisions of the Natural Gas Act, 52 Stat. 821, as amended, 15 U.S.C. 717–717w, are:

Section 4(a):

> All rates and charges made, demanded, or received by any natural-gas company or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges, shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful.

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contain only testimony, are paginated 1–1908. Volumes VI–VIII, which contain exhibits presented during the hearings, are paginated 1e–1146e. Volumes IX–XI, which contain pleadings, orders, and opinions, are paginated 1d–1157d. There are also two small volumes—a supplement paginated 1s–40s, and a table of contents for Volumes I–XI.

Section 4(e):

Whenever any such new schedule is filed the Commission shall have authority, either upon complaint of any State, municipality, State commission, or gas distributing company or upon its own initiative without complaint, at once, and if it so orders, without answer or formal pleading by the natural-gas company, but upon reasonable notice, to enter upon a hearing concerning the lawfulness of such rate, charge, classification, or service; and, pending such hearing and the decision thereon, the Commission, upon filing with such schedules and delivering to the natural-gas company affected thereby a statement in writing of its reasons for such suspension, may suspend the operation of such schedule and defer the use of such rate, charge, classification, or service, but not for a longer period than five months beyond the time when it would otherwise go into effect; and after full hearings either completed before or after the rate, charge, classification, or service goes into effect, the Commission may make such orders with reference thereto as would be proper in a proceeding initiated after it had become effective. If the proceeding has not been concluded and an order made at the expiration of the suspension period, on motion of the natural-gas company making the filing, the proposed change of rate, charge, classification, or service shall go into effect. Where increased rates or charges are thus made effective, the Commission may, by order, require the natural-gas company to furnish a bond, to be approved by the Commission, to refund any amounts ordered by the Commission, to keep

accurate accounts in detail of all amounts received by reason of such increase, specifying by whom and in whose behalf such amounts were paid, and, upon completion of the hearing and decision, to order such natural-gas company to refund, with interest, the portion of such increased rates or charges by its decision found not justified. At any hearing involving a rate or charge sought to be increased, the burden of proof to show that the increased rate or charge is just and reasonable shall be upon the natural-gas company, and the Commission shall give to the hearing and decision of such questions preference over other questions pending before it and decide the same as speedily as possible.

Section 5(a):

Whenever the Commission, after a hearing had upon its own motion or upon complaint of any State, municipality, State commission, or gas distributing company, shall find that any rate, charge, or classification demanded, observed, charged, or collected by any natural-gas company in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order: *Provided, however,* That the Commission shall have no power to order any increase in any rate contained in the currently effective schedule of such natural-gas company on file

with the Commission, unless such increase is in accordance with a new schedule filed by such natural-gas company; but the Commission may order a decrease where existing rates are unjust, unduly discriminatory, preferential, otherwise unlawful, or are not the lowest reasonable rates.

QUESTIONS PRESENTED

The Federal Power Commission fixed, on an area basis, the maximum just and reasonable rates which could be charged by independent producers of natural gas in the Permian Basin. The court below sustained the Commission's order in part and disapproved it in part. Its rulings adverse to the Commission were primarily predicated upon its view that the agency, in certain respects, had taken improper or insufficient measures to assure that the rates it was fixing would cover the revenue needs of the producers. We present these questions:

1. Whether the Commission erred in treating the risk, that a substantial portion of the gas produced in the Permian Basin would be of substandard quality, not as an item of cost but as a factor in determining the rate of return that the producers would be allowed on their investment, and whether the rate of return fixed by the Commission was adequate.

2. Whether the Commission was required to raise existing contractual rates that were below the area rates established in the proceeding.

3. Whether the Commission lacks power to order refunds of charges collected in excess of the area rates without first determining that such refunds will not

reduce the revenues of the Permian producers below their "revenue requirements" as a group.

4. Whether the Commission was required to specify the circumstances in which a producer would be granted exceptions to the area rates and must automatically grant a stay of those rates whenever a producer seeks an exception from the limitations which they impose. [3]

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[3] If certiorari is granted, we reserve the right to raise the additional questions whether the Commission adequately explained its Btu (heat content) quality standard, whether it gave adequate notice that it would prescribe quality standards in this proceeding, and whether those standards are reasonable and should have been upheld by the court below. While these questions may not warrant plenary review standing alone, to decide them would (assuming the Court agrees with us that in all other respects the Commission's order should be sustained) avoid further proceedings.

There is some language in the opinion of the court below that can be read—though we do not so read it—as intimating that the Commission must in all instances base rates upon costs (see Cal. Pet. App. 429). In fact, the Commission here held that oil-well gas could not be costed realistically and, on the basis that it has the same value as old gas-well gas, fixed its price at the same level (Statement, *infra*, p. 11). The court did not take specific exception to this method—which, we submit, was fully justified. We note that this Court has sanctioned departures from the strict cost-based rate-making method. See *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591, 615; *Colorado Interstate Gas Co.* v. *Federal Power Commission*, 324 U.S. 581, 601.

We also reserve the right to raise the collateral question whether the court below, in staying (on January 20, 1966) the effectiveness of the rate reductions ordered by the Commission, erred in prescribing a 4½ percent interest rate, when a 7 percent rate had been prescribed by the Commission in the order under review and had not been challenged in applications for rehearing filed with the Commission.

STATEMENT

In the proceeding from which this case arises, the Commission, for the first time, fixed just and reasonable rates for producers of natural gas on an area basis. The area in question is the Permian Basin, one of the nation's great oil and gas producing areas, located in west Texas and southeastern New Mexico (J.A. 529d).[4] The Commission's order was sustained in a number of major respects. This petition is directly concerned only with those aspects of the order that the court found were deficient.

Background of Area Ratemaking.—In 1954 this Court, in *Phillips Petroleum Co.* v. *Wisconsin,* 347 U.S. 672, held that the Commission's jurisdiction under the Natural Gas Act extended to sales of natural gas at the wellhead. The Commission had long regulated the rates of electric utilities and natural gas pipeline companies on an individual company cost-of-service basis, and after 1954 it made an attempt to apply that method to independent natural gas producers, which are numbered in the thousands. The first major independent producer case to reach the Commission on the merits was the original *Phillips* case on remand. *Phillips Petroleum Co.,* 24 F.P.C. 537. At that point (in 1960) the Commission concluded that the individual company cost-of-service approach was not an appropriate method for determining just and reasonable rates for independent

[4] The Permian Basin produces about 11 percent of all natural gas moving in interstate commerce.

producers and that in the future it would fix their rates on an area basis.

On the same day that it decided the *Phillips* case, the Commission issued Statement of General Policy No. 61–1 (24 F.P.C. 818), initiating the area-rate approach on an interim basis by announcing guideline ceiling prices for various producing areas, including the Permian Basin. The area-rate proceeding in issue here was initiated about three months later. The *Phillips* decision was later affirmed both by the court of appeals and by this Court. *Wisconsin* v. *Federal Power Commission,* 303 F. 2d 380 (C.A. D.C.); 373 U.S. 294. In rejecting the argument that the Commission had abused its discretion in terminating the Section 5(a) investigation of Phillips' rates in favor of determining its rates and those of the other independent producers on an area basis, this Court stated (373 U.S. at 310):

> * * * We respect the Commission's considered judgment, backed by sound and persuasive reasoning, that the individual company cost-of-service method is not a feasible or suitable one for regulating the rates of independent producers. We share the Commission's hopes that the area approach may prove to be the ultimate solution.

In addition to the Permian proceeding, area rate proceedings are in progress for the southern Louisiana area (oral argument before Commission scheduled for May 1967), the Hugoton-Anadarko area (hearing concluded, final briefs to examiner due on July 31, 1967), and the Texas Gulf Coast area (hearings concluded, final briefs to examiner also due on July 31,

1967). More than seventy-five percent of the nation's natural gas sales within the Commission's jurisdiction originate in these four areas (J.A. 540d–541d). On February 28, 1967, the Commission initiated a fifth proceeding that will encompass an additional 14 percent. *Area Rate Proceeding (Other Southwest Areas)*, Docket Nos. AR67–1 etc., 32 Fed. Reg. 3792, March 7, 1967.

The Commission's Decision.—There were 384 parties before the Commission in the Permian proceeding, including 336 gas producers who had been named as respondents and numerous representatives of consumer interests. Hearings began on October 11, 1961, and closed on September 12, 1963, and produced a transcript of more than 30,000 pages. The examiner issued his decision on September 17, 1964 (J.A. 97d–364d). The Commission, which heard oral argument for three days, issued an exhaustive opinion on August 5, 1965 (J.A. 516d–826d).

In its opinion, the Commission held, first, that it had both statutory and constitutional authority to determine independent producers' rates on an area basis and that the area approach should be adopted because "it is well adapted to the economic facts of the industry and the practical administrative problems of carrying out the primary purpose of the [Natural Gas] Act * * *" (J.A. 541d–552d). While making clear that it would "not permit a back-door approach to individual cost-of-service under the guise of avoiding confiscation * * *" (J.A. 551d), the Commission stated that it would permit producers to petition for special relief from the area rates it was fixing.

(J.A. 551d, 656d–660d). However, beyond stating that special relief would undoubtedly be justified if a producer could show that his out-of-pocket expenses in connection with the operation of a particular well were greater than the revenues he would obtain from the well under the applicable area rate, the Commission did not deem it feasible to attempt an exhaustive delineation of the situations in which such relief might be afforded. (It did, however, point out that in many, and perhaps most, instances where a basis for relief from the area rate might be demonstrated, it would probably be sufficient to permit the abandonment of unprofitable sales.) The Commission's order contemplates that the prospective area rates would become effective immediately, subject to later adjustment if a proper showing for relief were made, but that refunds would not be ordered if a petition for special relief was pending (J.A. 660d).

The Commission next held that the cost of "gas-well gas" (as distinguished from gas produced from oil wells as a by-product of oil production), determined from composite, industry-wide data, should be the yardstick for determining just and reasonable area rates (J.A. 573d–574d). It rejected contentions that area rates should be fixed primarily on the basis of negotiated contract prices (J.A. 552d–558d, 573d–574d). The Commission concluded that the just and reasonable Permian area rate for "new" gas-well gas (defined to mean all gas-well gas sold under contracts executed on or after January 1, 1961) of pipeline quality was 16.5 cents per Mcf (including taxes) in Texas and 15.5 cents per Mcf (plus taxes) in New

Mexico; and for all other gas (*i.e.*, "flowing" gas, comprising old gas-well gas and oil-well gas,[5] including residue gas therefrom) of pipeline quality, 14.5 cents per Mcf (including taxes) in Texas and 13.5 cents per Mcf (plus taxes) in New Mexico (J.A. 570d–572d, 688d–689d). The Commission also found that the public interest required that every producer in the area should be free to collect a minimum rate of 9 cents per Mcf for pipeline quality gas even if his contract specified a lower rate (J.A. 669d–671d).

The rate for new gas-well gas was based chiefly on the current cost (on a national basis) of finding gas, and is designed to ensure that the producers will have sufficient revenues to replenish exhausted reserves and meet any increases in demand (J.A. 563d–572d, 574d–612d, 800d–810d). The rate for old gas-well gas was determined in large measure on the basis of the historical costs of gas-well gas in the Permian Basin (J.A. 624d–639d, 810d–824d). Oil-well gas—which the Commission found could not be costed realistically—was found to have a value equivalent to old gas-well gas of the same quality, thus warranting the fixing of the same ceiling prices (J.A. 615d–624d).

In determining rates for both new gas-well and flowing gas of pipeline quality, the Commission made clear that the high 12-percent rate of return on the producers' investment which it was allowing (more than 5 cents per Mcf) for both new gas-well and flow-

[5] About two-thirds of the gas produced in the Permian Basin is oil-well gas. By contrast, oil-well gas represents only about one-third of the total gas production in the continental United States (J.A. 533d–534d).

ing gas reflected the "risk of finding gas of less than pipeline quality" in the Permian Basin (J.A. 602d, 614d, 633d, 1112d). The Commission's order requires deductions from the base rates (the rates for pipeline quality gas) for gas not conforming to the quality standards established by the order (J.A. 645d–656d, 1107d),[6] the amount of the deduction (except for heating value, for which both upward and downward adjustments were provided) to be measured by the purchaser's cost of bringing the purchased gas up to pipeline quality. The precise extent of these deductions was unknown at the time of the decision. The Commission estimated that they would range on the average from .7 cents to 1.5 cents per Mcf (J.A. 1115d).[7]

[6] These standards include the maximum amounts of carbon dioxide, hydrogen sulphide, sulphur and water that pipeline quality gas may contain, the minimum pressure at which it may be delivered, and its minimum heating value (Btu). The Commission found that in the Permian Basin gas having between 1000 and 1050 Btu's was of pipeline quality. Accordingly, proportional upward or downward adjustments from the base rate were provided for gas outside this range. In the original order, these Btu adjustments were limited to new gas-well gas, but on rehearing, in response to the producers' contentions, they were made applicable to all gas (J.A. 1108d).

[7] In order to arrive at the exact deduction for each rate schedule, the Commission provided that the seller and buyer should first attempt to agree on the amount of such deduction, the Commission only intervening if no agreement was reached. Agreements have now been filed and approved by the Commission with respect to substantially all gas subject to such deductions. See *Area Rate Proceeding (Permian Basin Area)*, Docket Nos. AR61–1 *et seq.*, Order Accepting Quality Statements, January 6, 1967. This order reveals that the quality deductions for old gas-well gas and old residue deliveries, based on the 1960 volumes of record in this case, are 0.78 cents and 0.89 cents per Mcf respectively.

The Commission agreed with the examiner that small producers should receive special treatment and that any producer whose annual sales subject to the Commission's jurisdiction were less than 10 million Mcf of gas nationally should be classified as "small." While the examiner would have exempted small producers from direct price control, the Commission decided that the area rates should be applicable to small producers, but without downward adjustments for gas of less than pipeline quality.[8] In addition, the Commission instituted a rulemaking proceeding (since completed) to relax the requirements for certificates of public convenience and necessity and annual reports by small producers (J.A. 675d–682d; 30 Fed. Reg. 10058).

The Commission imposed a moratorium on filing any increased rates in excess of the applicable area rate until January 1, 1968. The Commission found that, without "a moratorium, the conclusion of one area proceeding would only signal the beginning of the next, and just and reasonable rates for consumers would always be one area proceeding away" (J.A. 662d). It stressed that costs had remained stable since 1960 and were likely to continue so during the moratorium (J.A. 660d–669d).

With respect to rates that had been collected subject to refund under Section 4(e) of the Natural Gas Act (a number of such refund proceedings had been consolidated with the Permian area rate proceeding), the

[8] If a small producer chooses to take advantage of upward Btu adjustments, however, he must also take into account all other quality adjustments (J.A. 675d).

Commission ruled that, by further order, it would require refunds for the difference between the amounts actually collected and the amounts that would have been received under the applicable area rate, taking into account quality adjustments (J.A. 672d–675d).

The Court of Appeals' Decision.—Petitions to review the Commission's order were filed by numerous producers and the States of Texas and New Mexico. The court below sustained the order in a number of respects (see Cal. Pet. App. 392–411, 417–418, 426–427). It found no constitutional or statutory inhibition against the use of the area rate method for fixing independent producer rates, and held that the Commission had not abused its discretion in adopting that method. It deemed reasonable the Commission's conclusion that competition could not be relied upon to fix a just and reasonable rate and that the Permian Basin was a proper rate area. It upheld the Commission's adoption of the two-price system for new gas-well and flowing gas and the division date between the two. It accepted the Commission's cost calculations. It held that the Commission had authority to impose a moratorium on price increases above the area rate and that the Commission had reasonably exercised that power in the premises. It also upheld the Commission's treatment of small producers and the Commission's refund ruling.[9]

[9] The court also rejected contentions that Commissioners Black and Swidler were disqualified to participate because they had entered the proceeding with views on important economic matters in issue; that in fixing rates the Commission had interfered with the taxing powers of the States of Texas and New

Nevertheless, the court set aside the Commission's order and remanded the case to the Commission for further proceedings. It held that the Commission's conclusion that the rates "fixed 'provide a fair relationship between the aggregate price the consumer pays and the aggregate costs that the producers incur' in the Permian Basin" did not conform to the test of *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591, because costs and revenues had not been strictly equated and neither the producers' costs nor their revenues were known (Cal. App. 411–413, 427, 431). It said that "under Hope, and under Second Phillips, the area producers, as a group, are entitled to recover their prudent operation expenses and capital costs with a return commensurate to the risk and sufficient to attract capital" (*id.*, p. 430).

More particularly, the court found that no determination of the revenues which the area rates would produce could have been made because the record (in its view) did not disclose the revenue impact of the quality deductions. For this reason, the court refused to pass on the adequacy of the rate of return allowed on gas-well gas; it reasoned that the lack of evidence as to the impact of the quality deductions made a determination of the adequacy of the return allowance impossible. It also stated that the Commission had erred in treating the possibility of finding gas that was not of pipeline quality as a risk to be considered in determining the rate of return, rather than as an

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Mexico; and that the Commission had inadequately considered the interests of the producing States.

item of cost of service. (Cal. Pet. App. 421–423, 425–426.)

Further, the court, noting that some Permian Basin contracts specify prices below the area rates, held that the Commission should have fixed minimum rates high enough to assure recovery of the "revenue requirements" of the Permian producers as a group (Cal. Pet. App. 423–425).

The court also found wanting the Commission's provision for special relief from area rates, finding the provision "so vague and nebulous that neither [the producers] nor a court can determine what relief is being granted," and holding that an "adequate savings clause should contain guidelines which if followed by an aggrieved producer will permit it to be heard promptly and to have a stay of the general rate order until its claim for exemption is decided. It is not enough to say in effect that confiscation will be prevented. Confiscation is an individual proposition and the individual is entitled to be heard." (Cal. Pet. App. 418–419.)[10]

On rehearing, the court held that its original approval of the Commission's refund ruling had been erroneous. It concluded instead that no refund obligation could be imposed for any period in which there was a "group revenue deficiency." "In fixing

[10] The court also said that it did "not understand" the Commission's reasons for using a range between 1000 Btu's and 1050 Btu's, rather than a fixed figure, as the pipeline quality standard for heating value (Cal. Pet. App. 421) and left open the producers' contention that they had not been given adequate notice that the Commission would prescribe quality standards in this proceeding (*id.*, pp. 420–421).

an area rate," it said, "the Commission must consider the effect which past and potential refunds have on the balancing of group revenues with group revenue requirements." (App. B, *infra*, p. 46.)

REASONS FOR GRANTING THE WRIT

In its landmark decision in this case, the Federal Power Commission determined the rates for the future, along with refund liability for past years, of the hundreds of independent natural gas producers in the Permian Basin of Texas and New Mexico. The importance of the case—to consumers, producers, and the Commission—need not be labored. The Permian Basin accounts for some 11 percent of all natural gas moving into the interstate market, and the refund liability alone involved in this proceeding amounts to perhaps $40 million. Beyond that, the decision is the first in which producers' rates have been set on an area, rather than on an individual company cost-of-service, basis. The outcome here will guide the Commission in regulating the remaining gas-producing areas in the country.[11]

The court below sustained the Commission's decision in part. A number of the producers who were parties below have already filed (and others, we are informed, intend to file) petitions for certiorari challenging this aspect of the court's judgment. In view of the many novel and important issues of federal regulation that are involved, we support the

[11] The Commission is currently engaged in area proceedings which, together with the proceeding here under review, involve almost 90 percent of all natural gas sales for the interstate market (pp. 8–9, *supra*).

granting of these petitions (as well as the petitions by consumer interests, which support the Commission's order in its entirety). In other important respects, discussed below, the court rejected the Commission's approach. These issues, too, warrant review by this Court. Quite apart from their intrinsic importance, the questions we present should be embraced by the grant of certiorari so that the Court can treat the Commission's order *in solido*. This is appropriate both because virtually all of the issues involved in the order's validity are interrelated to some extent, and because of the obvious desirability of winding up this first area proceeding at the earliest possible date so that the area approach can be expeditiously extended to the other producing areas. Accordingly, if this petition is granted we shall urge the Court to sustain the Commission's order in its entirety.

In fixing area rates using the cost of gas-well gas as a yardstick, the Commission did not set out to match the producers' revenues as a group to their costs as might be done where rates of an individual public utility are determined on the basis of its particular cost of service. It held, however, that its "uniform ceiling price for the area will provide a fair relationship between the aggregate price the consumer pays and the aggregate costs that the producers incur." (J.A. 548d.) The court of appeals, while purporting to uphold the basic legitimacy of the area approach, rejected the "fair relationship" standard by reference to language in *Federal Power Commission* v. *Hope Natural*

Gas Co., 320 U.S. 591, 603, that gas rates must be so fixed as to return not only the company's operating expenses but also its capital costs, and that the return to the equity owner must be commensurate "with returns on investments in other enterprises having corresponding risks" and "sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital." (Cal. Pet. App. 411–412.) Tested by this standard, the court found the Commission's order deficient in a number of particulars.

We do not read the *Hope* opinion as in conflict with the concept of "fair relationship" articulated by the Commission. On the contrary, that standard seems implicit in *Hope*, where the Court stated "that the Commission [is] not bound to the use of any single formula or combination of formulae in determining rates"; that it "is not theory but the impact of the rate orders which counts"; and that "[i]f the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at an end." 320 U.S. at 602. At all events, we think the court below plainly erred in holding that the Commission did not give adequate attention to the revenue needs of the producers.

1. The court held that the Commission failed to appraise the impact that the deductions from base area rates necessitated by quality deficiencies would have on the revenues of the producers. The court seems, however, to have overlooked the fact that while the record did not permit an estimate to be made of the specific costs of removing specific impurities, it showed—and

the Commission found—that, on the average, Permian gas would have to be discounted within a range of .7 to 1.5 cents per Mcf from the area rate for pipeline quality gas by reason of its generally substandard quality (see J.A. 1115d). In fixing area rates here, the Commission allowed a higher than usual rate of return—12 percent, or more than 5 cents per Mcf—expressly to cover, *inter alia*, the risk of finding substandard gas for which a quality deduction would have to be made. The Commission was not, as the court below thought, required to treat the deduction as a cost. The method chosen was reasonable and accomplished the same result—fixing a price reflecting the substandard quality of most Permian gas—as the method preferred by the court. The 12 percent rate, moreover, was clearly an adequate one for this purpose.

2. A similar concern with the revenue needs of the producers led the court below to hold that the Commission must set minimum rates high enough to assure that producers will not (due to lower prices fixed by some of their contracts with gas purchasers) realize less than the revenues which the area rates would provide. This ruling is directly contrary to *United Gas Pipe Line Co.* v. *Mobile Gas Service Corp.*, 350 U.S. 332, and *Federal Power Commission* v. *Sierra Pacific Power Co.*, 350 U.S. 348. Those cases establish that a natural gas company is not entitled to charge a higher rate than that fixed by its contract with the purchaser even if that rate is below the just and reasonable rate, unless the contract rate is "so low as to adversely affect the public interest—as where it might impair the financial ability of the

public utility to continue its service, cast upon consumers an excessive burden, or be unduly discriminatory" (350 U.S. at 355). As the Commission pointed out, no showing was made here that the public interest required abrogating low contract prices, save those below 9 cents per Mcf (J.A. 669d–671d). The court below pointed to no evidence contradicting this finding; and we submit that there is none.

A closely related error was the court's ruling, on rehearing, that no refunds may be ordered for any period in which the Permian producers as a group show a revenue deficiency measured by the area rates fixed by the Commission. Since low contract rates can only be raised prospectively, this ruling would apparently permit producers to retain excessive charges collected prior to the Commission's order under some rate schedules in order to offset low contractual rates under other rate schedules. This result is plainly at odds with this Court's view in *Federal Power Commission* v. *Tennessee Gas Transmission Co.*, 371 U.S. 145, 153, that a natural gas company's "losses in the first instance do not justify its illegal gain in the latter." See, also, *Federal Power Commission* v. *Natural Gas Pipeline Co.*, 315 U.S. 575, 590. Just as the producers are not entitled to have existing contractual rates revised upwards to conform to the area rates, they cannot escape refund liability for past overcharges by pointing to the fact that other sales were governed by unfavorable contracts.

3. The Commission held that it would permit an exception to the area rates if a producer showed that those rates failed to cover his out-of-pocket expenses. The

Commission did not suggest that this was the only circumstance in which an exception to area rates would be allowed, but found it premature to specify others. The court below—again apparently out of concern that the Commission's order gave insufficient protection to the revenue needs of the producers—held that the Commission must spell out the exact circumstances in which exceptions would be allowed. We urge that the Commission was entitled, in its discretion, to postpone the formulation of detailed exceptions to its area rates to a later date. No producer was injured by this procedure. Nor would it be practicable, at this early stage in the evolution of the area technique, to satisfy the court's requirement of particularity.

Equally unjustified was the court's correlative ruling that any producer who claims an exception—whatever his grounds—is automatically entitled to a stay of the area rate until his claim is decided. *New England Divisions Case,* 261 U.S. 184. Surely, in this as in other regulatory contexts, the appropriateness of a stay depends on the circumstances. *Virginia Petroleum Jobbers Ass'n.* v. *Federal Power Commission,* 259 F. 2d 921 (C.A. D.C.); see *Federal Power Commission* v. *Tennessee Gas Transmission Co.,* 371 U.S. 145; *United Gas Improvement Co.* v. *Callery Properties, Inc.* 382 U.S. 223, 230.

Conclusion

The petition for a writ of certiorari should be granted.

Respectfully submitted.

Thurgood Marshall,
Solicitor General.
Ralph S. Spritzer,
Richard A. Posner,
Assistants to the Solicitor General.

Richard A. Solomon,
General Counsel,
Peter H. Schiff,
Acting Solicitor,
Federal Power Commission.

May 1967.

APPENDIX A

UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

THIRTEENTH DAY, JANUARY TERM, FRIDAY, JANUARY 20TH, 1967

* * * * *

BEFORE HONORABLE DAVID T. LEWIS, HONORABLE JEAN S. BREITENSTEIN AND HONORABLE DELMAS C. HILL, CIRCUIT JUDGES

8385

SKELLY OIL COMPANY, PETITIONER

vs.

FEDERAL POWER COMMISSION, RESPONDENT

On Petition to Review an Order of the Federal Power Commission

This cause came on to be heard on petition to review an order of the Federal Power Commission and motion to adduce additional evidence and was argued by counsel.

On consideration whereof, it is ordered by this court that the motion to adduce additional evidence is hereby denied. The petition to review is granted and the case is remanded to the Commission for further proceedings consistent with the opinion of the court.

8409

PHILLIPS PETROLEUM COMPANY, PETITIONER

vs.

FEDERAL POWER COMMISSION, RESPONDENT

On Petition to Review an Order of the Federal Power Commission

This cause came on to be heard on petition to review an order of the Federal Power Commission and motion to adduce additional evidence and was argued by counsel.

On consideration whereof, it is ordered by this court that the motion to adduce additional evidence is hereby denied. The petition to review is granted and the case is remanded to the Commission for further proceedings consistent with the opinion of the court.

8440

WARREN PETROLEUM CORPORATION, PETITIONER

vs.

FEDERAL POWER COMMISSION, RESPONDENT

On Petition to Review an Order of the Federal Power Commission

This cause came on to be heard on petition to review an order of the Federal Power Commission and motion to adduce additional evidence and was argued by counsel.

On consideration whereof, it is ordered by this court that the motion to adduce additional evidence is hereby denied. The petition to review is granted and

the case is remanded to the Commission for further proceedings consistent with the opinion of the court.

8455

MOBIL OIL CORPORATION (FORMERLY SOCONY MOBIL OIL COMPANY, INC.), PETITIONER

vs.

FEDERAL POWER COMMISSION, RESPONDENT

On Petition to Review an Order of the Federal Power Commission

This cause came on to be heard on petition to review an order of the Federal Power Commission and motion to adduce additional evidence and was argued by counsel.

On consideration whereof, it is ordered by this court that the motion to adduce additional evidence is hereby denied. The petition to review is granted and the case is remanded to the Commission for further proceedings consistent with the opinion of the court.

8458

PAN AMERICAN PETROLEUM CORPORATION, PETITIONER

vs.

FEDERAL POWER COMMISSION, RESPONDENT

On Petition to Review an Order of the Federal Power Commission

This cause came on to be heard on petition to review an order of the Federal Power Commission and motion to adduce additional evidence and was argued by counsel.

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On consideration whereof, it is ordered by this court that the motion to adduce additional evidence is hereby denied. The petition to review is granted and the case is remanded to the Commission for further proceedings consistent with the opinion of the court.

8460

NORTHERN NATURAL GAS PRODUCING COMPANY, PETITIONER

vs.

FEDERAL POWER COMMISSION, RESPONDENT

On Petition to Review an Order of the Federal Power Commission

This cause came on to be heard on petition to review an order of the Federal Power Commission and motion to adduce additional evidence and was argued by counsel.

On consideration whereof, it is ordered by this court that the motion to adduce additional evidence is hereby denied. The petition to review is granted and the case is remanded to the Commission for further proceedings consistent with the opinion of the court.

8479

STANDARD OIL COMPANY OF TEXAS, A DIVISION OF CHEVRON OIL COMPANY, PETITIONER

vs.

FEDERAL POWER COMMISSION, RESPONDENT

On Petition to Review an Order of the Federal Power Commission

This cause came on to be heard on petition to review an order of the Federal Power Commission and

motion to adduce additional evidence and was argued by counsel.

On consideration whereof, it is ordered by this court that the motion to adduce additional evidence is hereby denied. The petition to review is granted and the case is remanded to the Commission for further proceedings consistent with the opinion of the court.

8482

TEXACO, INC., PETITIONER

vs.

FEDERAL POWER COMMISSION, RESPONDENT

On Petition to Review an Order of the Federal Power Commission

This cause came on to be heard on petition to review an order of the Federal Power Commission and motion to adduce additional evidence and was argued by counsel.

On consideration whereof, it is ordered by this court that the motion to adduce additional evidence is hereby denied. The petition to review is granted and the case is remanded to the Commission for further proceedings consistent with the opinion of the court.

8487

HUNT OIL COMPANY ET AL., PETITIONERS

vs.

FEDERAL POWER COMMISSION, RESPONDENT

On Petition to Review an Order of the Federal Power Commission

This cause came on to be heard on petition to review an order of the Federal Power Commission and motion to adduce additional evidence and was argued by counsel.

On consideration whereof, it is ordered by this court that the motion to adduce additional evidence is hereby denied. The petition to review is granted and the case is remanded to the Commission for further proceedings consistent with the opinion of the court.

8488

HUMBLE OIL & REFINING COMPANY, PETITIONER

vs.

FEDERAL POWER COMMISSION, RESPONDENT

On Petition to Review an Order of the Federal Power Commission

This cause came on to be heard on petition to review an order of the Federal Power Commission and motion to adduce additional evidence and was argued by counsel.

On consideration whereof, it is ordered by this court that the motion to adduce additional evidence

is hereby denied. The petition to review is granted and the case is remanded to the Commission for further proceedings consistent with the opinion of the court.

8489

SHELL OIL COMPANY, PETITIONER

vs.

FEDERAL POWER COMMISSION, RESPONDENT

On Petition to Review an Order of the Federal Power Commission

This cause came on to be heard on petition to review an order of the Federal Power Commission and motion to adduce additional evidence and was argued by counsel.

On consideration whereof, it is ordered by this court that the motion to adduce additional evidence is hereby denied. The petition to review is granted and the case is remanded to the Commission for further proceedings consistent with the opinion of the court.

8490

THE ATLANTIC RICHFIELD COMPANY, ETC., ET AL., PETITIONERS

vs.

FEDERAL POWER COMMISSION, RESPONDENT

On Petition to Review an Order of the Federal Power Commission

This cause came on to be heard on petition to review an order of the Federal Power Commission and motion to adduce additional evidence and was argued by counsel.

On consideration whereof, it is ordered by this court that the motion to adduce additional evidence is hereby denied. The petition to review is granted and the case is remanded to the Commission for further proceedings consistent with the opinion of the court.

8493

CONTINENTAL OIL COMPANY ET AL., PETITIONERS

vs.

FEDERAL POWER COMMISSION, RESPONDENT

On Petition to Review an Order of the Federal Power Commission

This cause came on to be heard on petition to review an order of the Federal Power Commission and motion to adduce additional evidence and was argued by counsel.

On consideration whereof, it is ordered by this court that the motion to adduce additional evidence is hereby denied. The petition to review is granted and the case is remanded to the Commission for further proceedings consistent with the opinion of the court.

8494

MARATHON OIL COMPANY, PETITIONER

vs.

FEDERAL POWER COMMISSION, RESPONDENT

On Petition to Review an Order of the Federal Power Commission

This cause came on to be heard on petition to review an order of the Federal Power Commission and motion to adduce additional evidence and was argued by counsel.

On consideration whereof, it is ordered by this court that the motion to adduce additional evidence is hereby denied.. The petition to review is granted and the case is remanded to the Commission for further proceedings consistent with the opinion of the court.

8495

SUN OIL COMPANY, PETITIONER

vs.

FEDERAL POWER COMMISSION, RESPONDENT

On Petition to Review an Order of the Federal Power Commission

This cause came on to be heard on petition to review an order of the Federal Power Commission and motion to adduce additional evidence and was argued by counsel.

On consideration whereof, it is ordered by this court that the motion to adduce additional evidence is hereby denied. The petition to review is granted and the case is remanded to the Commission for further proceedings consistent with the opinion of the court.

8496

INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA, PETITIONER

vs.

FEDERAL POWER COMMISSION, RESPONDENT

On Petition To Review an Order of the Federal Power Commission

This cause came on to be heard on petition to review an order of the Federal Power Commission and mo-

tion to adduce additional evidence and was argued by counsel.

On consideration whereof, it is ordered by this court that the motion to adduce additional evidence is hereby denied. The petition to review is granted and the case is remanded to the Commission for further proceedings consistent with the opinion of the court.

8497

THE BRITISH-AMERICAN OIL PRODUCING COMPANY, PETITIONER

vs.

FEDERAL POWER COMMISSION, RESPONDENT

On Petition To Review an Order of the Federal Power Commission

This cause came on to be heard on petition to review an order of the Federal Power Commission and motion to adduce additional evidence and was argued by counsel.

On consideration whereof, it is ordered by this court that the motion to adduce additional evidence is hereby denied. The petition to review is granted and the case is remanded to the Commission for further proceedings consistent with the opinion of the court.

8501

UNION TEXAS PETROLEUM, A DIVISION OF ALLIED CHEMICAL CORPORATION, PETITIONER

vs.

FEDERAL POWER COMMISSION, RESPONDENT

On Petition to Review an Order of the Federal Power Commission

This cause came on to be heard on petition to review an order of the Federal Power Commission and motion to adduce additional evidence and was argued by counsel.

On consideration whereof, it is ordered by this court that the motion to adduce additional evidence is hereby denied. The petition to review is granted and the case is remanded to the Commission for further proceedings consistent with the opinion of the court.

8505

MIDHURST OIL CORPORATION, PETITIONER

vs.

FEDERAL POWER COMMISSION, RESPONDENT

On Petition to Review an Order of the Federal Power Commission

This cause came on to be heard on petition to review an order of the Federal Power Commission and motion to adduce additional evidence and was argued by counsel.

On consideration whereof, it is ordered by this court that the motion to adduce additional evidence

is hereby denied. The petition to review is granted and the case is remanded to the Commission for further proceedings consistent with the opinion of the court.

8510

THE SUPERIOR OIL COMPANY, PETITIONER

vs.

FEDERAL POWER COMMISSION, RESPONDENT

On Petition To Review an Order of the Federal Power Commission

This cause came on to be heard on petition to review an order of the Federal Power Commission and motion to adduce additional evidence and was argued by counsel.

On consideration whereof, it is ordered by this court that the motion to adduce additional evidence is hereby denied. The petition to review is granted and the case is remanded to the Commission for further proceedings consistent with the opinion of the court.

8511

PERRY R. BASS ET AL., PETITIONERS

vs.

FEDERAL POWER COMMISSION, RESPONDENT

On Petition To Review an Order of the Federal Power Commission

This cause came on to be heard on petition to review an order of the Federal Power Commission and motion to adduce additional evidence and was argued by counsel.

On consideration whereof, it is ordered by this court

that the motion to adduce additional evidence is hereby denied. The petition to review is granted and the case is remanded to the Commission for further proceedings consistent with the opinion of the court.

8517

COLUMBIAN CARBON COMPANY JOINTLY WITH COLTEXO CORPORATION, PETITIONER

vs.

FEDERAL POWER COMMISSION, RESPONDENT

On Petition to Review an Order of the Federal Power Commission

This cause came on to be heard on petition to review an order of the Federal Power Commission and motion to adduce additional evidence and was argued by counsel.

On consideration whereof, it is ordered by this court that the motion to adduce additional evidence is hereby denied. The petition to review is granted and the case is remanded to the Commission for further proceedings consistent with the opinion of the court.

8519

THE STATE OF TEXAS, PETITIONER

vs.

FEDERAL POWER COMMISSION, RESPONDENT

On Petition to Review an Order of the Federal Power Commission

This cause came on to be heard on petition to review an order of the Federal Power Commmission and motion to adduce additional evidence and was argued by counsel.

On consideration whereof, it is ordered by this court that the motion to adduce additional evidence is hereby denied. The petition to review is granted and the case is remanded to the Commission for further proceedings consistent with the opinion of the court.

8521

BIG CHIEF DRILLING COMPANY JOINTLY WITH KING-STEVENSON OIL COMPANY, INC., AND SERVICE DRILLING COMPANY, PETITIONERS

vs.

FEDERAL POWER COMMISSION, RESPONDENT

On Petition to Review an Order of the Federal Power Commission

This cause came on to be heard on petition to review an order of the Federal Power Commission and motion to adduce additional evidence and was argued by counsel.

On consideration whereof, it is ordered by this court that the motion to adduce additional evidence is hereby denied. The petition to review is granted and the case is remanded to the Commission for further proceedings consistent with the opinion of the court.

8528

TEXAS INDEPENDENT PRODUCERS AND ROYALTY OWNERS ASSOCIATION JOINTLY WITH WEST CENTRAL TEXAS OIL AND GAS ASSOCIATION, PETITIONERS

vs.

FEDERAL POWER COMMISSION, RESPONDENT

On Petition to Review an Order of the Federal Power Commission

This cause came on to be heard on the petition to review an order of the Federal Power Commission and motion to adduce additional evidence and was argued by counsel.

On consideration whereof, it is ordered by this court that the motion to adduce additional evidence is hereby denied. The petition to review is granted and the case is remanded to the Commission for further proceedings consistent with the opinion of the court.

8529

STATE OF NEW MEXICO, PETITIONER

vs.

FEDERAL POWER COMMISSION, RESPONDENT

On Petition to Review an Order of the Federal Power Commission

This cause came on to be heard on petition to review an order of the Federal Power Commission and motion to adduce additional evidence and was argued by counsel.

On consideration whereof, it is ordered by this court that the motion to adduce additional evidence is here-

by denied. The petition to review is granted and the case is remanded to the Commission for further proceedings consistent with the opinion of the court.

8534

GULF OIL CORPORATION, PETITIONER

vs.

FEDERAL POWER COMMISSION, RESPONDENT

On Petition to Review an Order of the Federal Power Commission

This cause came on to be heard on the petition to review an order of the Federal Power Commission and motion to adduce additional evidence and was argued by counsel.

On consideration whereof, it is ordered by this court that the motion to adduce additional evidence is hereby denied. The petition to review is granted and the case is remanded to the Commission for further proceedings consistent with the opinion of the court.

8540

MARATHON OIL COMPANY, PETITIONER

vs.

FEDERAL POWER COMMISSION, RESPONDENT

On Petition to Review an Order of the Federal Power Commission

This cause came on to be heard on petition to review an order of the Federal Power Commission and motion to adduce additional evidence and was argued by counsel.

On consideration whereof, it is ordered by this court

that the motion to adduce additional evidence is hereby denied. The petition to review is granted and the case is remanded to the Commission for further proceedings consistent with the opinion of the court.

8541

TEXACO, INC., PETITIONER

vs.

FEDERAL POWER COMMISSION, RESPONDENT

On Petition to Review an Order of the Federal Power Commission

This cause came on to be heard on the petition to review an order of the Federal Power Commission and motion to adduce additional evidence and was argued by counsel.

On consideration whereof, it is ordered by this court that the motion to adduce additional evidence is hereby denied. The petition to review is granted and the case is remanded to the Commission for further proceedings consistent with the opinion of the court.

8542

AMERADA PETROLEUM CORPORATION, PETITIONER

vs.

FEDERAL POWER COMMISSION, RESPONDENT

On Petition to Review an Order of the Federal Power Commission

This cause came on to be heard on petition to review an order of the Federal Power Commission and motion to adduce additional evidence and was argued by counsel.

On consideration whereof, it is ordered by this court that the motion to adduce additional evidence is hereby denied. The petition to review is granted and the case is remanded to the Commission for further proceedings consistent with the opinion of the court.

8588

MOBIL OIL CORPORATION, PETITIONER

vs.

FEDERAL POWER COMMISSION, RESPONDENT

On Petition to Review an Order of the Federal Power Commission

This cause came on to be heard on petition to review an order of the Federal Power Commission and motion to adduce additional evidence and was argued by counsel.

On consideration whereof, it is ordered by this court that the motion to adduce additional evidence is hereby denied. The petition to review is granted and the case is remanded to the Commission for further proceedings consistent with the opinion of the court.

8589

J. C. BARNES ET AL., PETITIONERS

vs.

FEDERAL POWER COMMISSION, RESPONDENT

On Petition to Review an Order of the Federal Power Commission

This cause came on to be heard on petition to review an order of the Federal Power Commission and motion to adduce additional evidence and was argued by counsel.

On consideration whereof, it is ordered by this court that the motion to adduce additional evidence is hereby denied. The petition to review is granted and the case is remanded to the Commission for further proceedings consistent with the opinion of the court.

~~Before Honorable Alfred P. Murrah, Chief Judge.~~

APPENDIX B

UNITED STATES COURT OF APPEALS

TENTH CIRCUIT

MARCH TERM, 1967
[April 18, 1967]

Nos. 8385 etc.
SKELLY OIL COMPANY, ET AL., PETITIONERS
v.
FEDERAL POWER COMMISSION, RESPONDENT

On rehearing.

Per Curiam.

Texaco Inc. asserts that the opinion is not clear as to the disposition of its Docket No. C161–879 in which, by an order separate and apart from Opinions Nos. 468 and 468–A and their accompanying orders, a § 7 certificate was issued at a rate of 14.5 cents less quality deductions. This separate order shows that the Commission treated the area rate as the in-line rate for § 7 certificates.

The order on this docket was lost in the mass of material presented to us. No party made a point of it. We have reconsidered the Texaco petition for review and have concluded that it is sufficiently broad to cover such order. It should receive the same treatment as the § 4 and § 5 proceedings. Accordingly, the remand includes the separate order entered in Docket No. C161–879.

We note that in its disposition of this particular docket the Commission took the position that an estab-

lished area rate automatically becomes the in-line rate for a § 7 proceeding. The same position was taken by the Commission in its Opinion No. 484 which we are today reversing by our decision in Nos. 8723 etc.—Phillips Petroleum Company, et al., v. Federal Power Commission, —— F. 2d ——. We there hold that in a § 7 application heard by the Commission after its Permian decision the adoption of the area rate as an in-line rate must fall because we have rejected the area rate. We do not there, and we do not here, express either approval or disapproval of the principle that an area rate established in a § 5 proceeding automatically becomes an in-line rate for a § 7 proceeding. The validity of such a principle may be affected by the final determination of the validity of the Permian Basin area rate.

Various producers insist that we erred in our treatment of refunds. We held that refunds must be on a company-by-company and schedule-by-schedule basis. We are now convinced that such holding was wrong and is inconsistent with our conclusion that satisfaction of the end result test requires rates which will equate group revenues with group revenue requirements.

The refunds in question relate to collections made during the so-called "locked-in" periods, i.e., the periods during which an increased rate, later superseded by a further increase, is effective. See Second Phillips, 373 U.S. 294, 298, fn. 5. In that case the Court said that on the locked-in rate issue "the sole question was whether all or any part of the increases had to be refunded by Phillips." The Court pointed out that the Commission decided that the increases did not bring revenues up to cost of service, and held that the Commission "properly concluded" that "no refund obligations could be imposed." *Id.* at 306.

We are now convinced that this treatment of refund obligations for locked-in rates in the case of an individual company in Second Phillips must be applied on a group basis when an area rate is fixed and tested by the end result. We are also convinced that our reliance on Federal Power Commission v. Tennessee Gas Transmission Co., 371 U.S. 145, was misplaced. That case dealt with zone rates. The Second Phillips decision on locked-in rates came later.

This modification of the opinion means that no refund obligation may be imposed for a period in which there is a group revenue deficiency. When group revenues exceed group revenue requirements, refunds may be ordered on some equitable contract-by-contract basis. In fixing an area rate, the Commission must consider the effect which past and potential refunds have on the balancing of group revenues with group revenue requirements.

In all respects, except those specifically noted herein, the petitions for rehearing are severally denied.

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In the Supreme Court of the United States

OCTOBER TERM, 1966

FEDERAL POWER COMMISSION, PETITIONER

v.

SKELLY OIL COMPANY, ET AL.
("Permian Basin Area Rate Case")

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

MOTION TO EXPEDITE PROCEEDINGS

THURGOOD MARSHALL,
Solicitor General,
Department of Justice,
Washington, D.C. 20530.

In the Supreme Court of the United States

OCTOBER TERM, 1966

No.

FEDERAL POWER COMMISSION, PETITIONER

v.

SKELLY OIL COMPANY, ET AL.
("Permian Basin Area Rate Case")

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

MOTION TO EXPEDITE PROCEEDINGS

The petition for a writ of certiorari contemporaneously filed by the Federal Power Commission in this case seeks review of the judgment of the Court of Appeals for the Tenth Circuit in *Skelly Oil Co.* v. *Federal Power Commission,* entered on January 20, 1967, which approved in part and disapproved in part the Federal Power Commission's order fixing just and reasonable rates for independent producers of natural gas in the Permian Basin. Eight other petitions seeking review of the same judgment have

261-268—67

been filed.[1] Three additional parties below have obtained extensions of time until June 19, 1967, for filing petitions for writs of certiorari.[2] A number of other parties—producers who filed petitions for rehearing in the court of appeals—have until July 17, 1967, to file petitions for certiorari, the court of appeals having entered its order on rehearing on April 18. We anticipate that a number of such petitions for certiorari will be filed.

This is the first area rate case. On its outcome turns not merely the price of natural gas in one of the nation's major producing areas, but, even more importantly, the future employment of this method for regulating the rates of the thousands of independent natural gas producers throughout the country. Four other area cases now in progress, affecting most of the gas produced in the United States, will be largely governed by the decision herein. The importance to consumers, producers and the Commission alike of a prompt and authoritative resolution is manifest. The need for expedition and the multiplicity of parties prompt us to suggest a procedure that would, in our view, make for orderly and expe-

[1] The petitioners are Continental Oil Company and Midhurst Oil Corporation (No. 1274), The Superior Oil Company (No. 1287), States of New Mexico and Texas (No. 1291), Sun Oil Company (No. 1292), People and Public Utilities Commission of California (No. 1293), Hunt Oil Company, *et al.* (No. 1294), Pacific Gas and Electric Company, *et al.* (No. 1295), and Perry R. Bass, *et al.* (No. 1302).

[2] The City of Los Angeles, the City of San Diego, and the City and County of San Francisco.

ditious consideration of the case by this Court, without prejudice to any party.[3]

1. We suggest that the Court need not await the filing of additional petitions for certiorari before it acts on the pending petitions. The petitions that have already been filed provide a broad conspectus of the issues and afford ample basis, we believe, for a judgment that the Permian case warrants review by this Court. Several of the briefs in opposition are due on May 20, 1967, and there appears to be no reason why the other respondents cannot readily file their briefs in opposition (should they choose to oppose certiorari) by that day. Accordingly, we think the Court could appropriately consider the petitions at its next conference after May 20. This would permit the case to be briefed during the summer recess and argued early in the 1967 Term should the Court grant certiorari.

This course would not prejudice those parties below who elect not to file their petitions for certiorari until June or July.[4] In our petition for certiorari, we have stated our acquiescence in the grant of any other petition seeking review of the Tenth Circuit's decision, and we assume that, if the pending petitions are granted, subsequent petitions (so long as they are timely) will be granted also. We believe,

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[3] This motion is being served on all parties below.

[4] We point out that the original judgment in this case was entered on January 20, 1967, and that those parties who wish to file petitions prior to May 20, 1967, should experience no serious difficulty in doing so.

therefore, that it would be appropriate to direct all parties planning to file petitions to file their briefs on the merits in accordance with the schedule suggested below. We point out in this connection that all who were parties in the proceeding below are parties in this Court whether or not they file petitions seeking further review.

2. Each of the petitioners involved in these proceedings is, in reality, both petitioner and respondent, since each attacks certain portions of the Tenth Circuit's judgment while defending others. For this reason—and considering the number of parties—we suggest that the Court (if it adopts our previous suggestion) may wish to direct that all parties supporting the Commission's order file their opening briefs by August 25, 1967, and that all parties opposing the Commission's order file their briefs by September 25, 1967. Likewise we suggest that the parties filing their briefs on August 25, 1967, open the oral argument. Finally, we think that an allotment of four hours of argument to each side would be appropriate in view of the number of parties and the complexity of the issues.

In sum, we urge that the Court:

(1) Grant the pending petitions for certiorari promptly after responding briefs are filed on May 20, 1967;

(2) Direct that briefs on the merits by all parties supporting the Commission's order be filed by Au-

gust 25, 1967, and by those opposing it by September 25, 1967;[5]

(3) Allot four (4) hours of oral argument to each side, with the parties filing their briefs on August 25 to open, and the division of time among parties on each side to be decided by counsel.

Respectfully submitted.

THURGOOD MARSHALL,
Solicitor General.

MAY 1967.

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[5] This would of course apply to parties who filed petitions too late for disposition this Term as well as to all other parties.

U.S. GOVERNMENT PRINTING OFFICE: 1967

REPLY TO MOTION

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1966

No. ~~1342~~ 117

FEDERAL POWER COMMISSION, *Petitioner*,

v.

SKELLY OIL COMPANY, ET AL. ("Permian Basin Area Rate Case"), *Respondent*.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

ANSWER OF SUN OIL COMPANY TO MOTION TO EXPEDITE PROCEEDINGS

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May 11, 1967

PRESS OF BYRON S. ADAMS PRINTING, INC., WASHINGTON, D. C.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1966

No. 1342

FEDERAL POWER COMMISSION, *Petitioner,*

v.

SKELLY OIL COMPANY, ET AL. ("Permian Basin Area Rate Case"), *Respondent.*

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

---

ANSWER OF SUN OIL COMPANY TO MOTION TO EXPEDITE PROCEEDINGS

Comes now Sun Oil Company ("Sun") in answer to the Motion to Expedite Proceedings filed by the Federal Power Commission on May 1, 1967 concurrently with the Commission's petition for certiorari. Sun is a respondent in this case and in addition, by

petition filed April 18, 1967 in No. 1292, Sun seeks certiorari with respect to the same decision of the Court of Appeals for the Tenth Circuit.

By its Motion to Expedite Proceedings (p. 4) the Commission *inter alia* seeks a briefing schedule whereby parties supporting the Commission's order which the Tenth Circuit reviewed would file initial briefs on August 25, 1967, and those opposing the Commission's order would file briefs on September 25, 1967.[1] Also, the motion suggests that each of these groups be allotted four hours for oral argument with those supporting the Commission's order opening the argument.[2]

Sun vigorously opposes the above-described portion of the Commission's motion because it would provide the Commission with a distinct and unwarranted procedural advantage, would operate to deprive Sun of its rights as a petitioner, and would tend to confuse the proceedings before this Court rather than to aid the Court's determination.

(1) The rationale advanced for the procedure requested by the Commission is that there are a number of parties and each petitioner "is, in reality, both petitioner and respondent." The Commission makes no attempt to show, however, why this Court's normal

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[1] The Commission's motion (p. 3) also seeks to reduce the time for filing answers to its petition for certiorari so that answers may be filed to all pending petitions for certiorari on the Tenth Circuit action by May 20. Sun does not contemplate filing an answer to the Commission's petition.

[2] Although unstated in the motion, it is presumed that under the Commission's program those supporting its order would be permitted to file a reply brief in accordance with Rule 41(3) of this Court and to close the oral argument, in accordance with Rule 44(2).

processes would be ineffective, cumbersome or unfair in such circumstances.

It is submitted that it is in no way unusual for various parties dissatisfied with different aspects of a court of appeals' decision to petition for and be granted certiorari. This Court's rules anticipate that there will be cross-petitions seeking the grant of cross-writs [Rules 21(5) and 21(6)], and the rules further provide for argument in such circumstances [Rule 44(2)]. Also, this Court's reports show a substantial number of cases where parties are both petitioners and respondents.

The Commission has additionally failed to show that the arguments of the large number of parties involved in these proceedings could be treated any more expeditiously by categorizing the parties as to their position on the Commission opinion rather than the Tenth Circuit's decision. Just as individuals who have filed petitions for certiorari set forth varying issues, so also those who sought review of the Commission's opinion were not uniform in the positions they took. The Tenth Circuit's decision has in large measure sifted and separately presented these issues under descriptive subheadings so that the matters urged to this Court can often be directly keyed to sections of the Tenth Circuit's decision.

A forced grouping of parties in accordance with the position they took on the Commission's order before the Tenth Circuit acted would likely have the unfortunate effect of shifting the focus of these proceedings away from the Tenth Circuit's decision and back to the Commission's actions for what would amount to a

de novo review by this Court.[3] As a consequence, this Court would be deprived of the benefit of argument on the Tenth Circuit's reasoning, and the process of intermediate court review would be rendered ineffective.

(2) The Commission's suggestion also completely inverts the normal appeal practice whereby those who oppose the action of the tribunal below are petitioners and those who support the tribunal below are respondents. Thus, the Commission would assign those who support the Commission's order the role of petitioner, while those who oppose the Commission's order would be respondents. As a result, the Commission would reserve to itself and its allies the extended time for filing an initial brief under this Court's recess schedule, as well as the right to open and close, both in brief and argument. In contrast, Sun and others who are no less petitioners before this Court would be relegated to filing single briefs 30 days after the Commission's brief in which they must simultaneously advance their position as petitioners and answer the Commission's arguments. Furthermore, petitioners before this Court who oppose the Commission would presumably be denied the opportunity to make a rebuttal oral argument.[4]

---

[3] This would particularly be the case if the opening briefs of the Commission and its allies were strongly directed to a positive support of the Commission action rather than to the claimed error of the Tenth Circuit. The character of these opening briefs would of necessity tend to control the nature of answering briefs.

[4] Sun, of course, recognizes that in a proceeding of this type all petitioners cannot be given the opportunity to open and close in the literal sense. Nevertheless, the opportunity should be provided a petitioner such as Sun to rebut the principal arguments of respondents and other petitioners who follow it in the course of argument. Under the Commission's plan, only the Commission and its allies would have this opportunity.

(3) Sun does not object to this Court providing an aggregate of eight hours for oral argument as recommended by the Commission's motion, and, in fact, Sun joins in urging that the complexity and importance of these proceedings fully support such a time allocation. It is submitted, however, that this time should not be equally divided into two four-hour periods based on the parties' support or non-support of the Commission's order. In addition to the reasons discussed above why such grouping is improper, the division of oral argument on this basis would otherwise be most unfair and could produce a highly confusing presentation which would not aid the Court in its understanding of the important constitutional and statutory issues in this case.

At this stage of the proceedings it appears there will be at least three fundamental groupings among parties to the proceedings in this Court: (1) those in support of the Tenth Circuit's decision; (2) the Commission and its allies which disagree with the Tenth Circuit; and (3) petitioners who dispute the Tenth Circuit for reasons other than the Commission's. The latter, including Sun, individually present a variety of issues and may resolve into other groupings.

Under the Commission's plan for oral argument, the Commission and its allies would get a full four hours, while the other four hours would be assigned to the multitude of parties in the other two categories. Since the positions of the parties in these two other categories are by no means the same, there could result serious problems on an equitable subdivision of the time that would be available. In any event, however, the result would be an overbalancing of time in favor of the Commission and its allies as compared to either of the other groupings of parties.

In view of the above it is submitted that the dividing of the time for argument should be deferred pending the filing of briefs. By that time it is expected that the positions taken by various parties will reveal a realistic alignment upon which the time for argument can be assigned or stipulated.

WHEREFORE, for the reasons set forth above, Sun submits the following in answer to the Commission's motion of May 1, 1967:

(1) There is no valid reason for departing from the provisions of this Court's rules with respect to the filing of briefs and argument. Accordingly, the Commission's plan for aligning sides for brief and argument in accordance with the position taken on the Commission's order below should be denied.

(2) A total of eight hours' argument time should be allotted and any division of such time as among sides and among individual parties should be deferred, pending the filing of briefs.

Respectfully submitted,

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Attorneys for Sun Oil Company, Petitioner

May 11, 1967

BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

MAY 1967
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No. ~~1342~~

IN THE

Supreme Court of the United States

OCTOBER TERM, 1966

FEDERAL POWER COMMISSION,

Petitioner,

v.

SKELLY OIL COMPANY, ET AL.,

Respondents.

BRIEF IN OPPOSITION TO FEDERAL POWER COMMISSION'S MOTION TO EXPEDITE PROCEEDINGS

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FIDELITY PRINTING COMPANY, INC., HOUSTON

No. 1342

IN THE

Supreme Court of the United States

OCTOBER TERM, 1966

FEDERAL POWER COMMISSION,

Petitioner,

v.

SKELLY OIL COMPANY, ET AL.,

Respondents.

BRIEF IN OPPOSITION TO FEDERAL POWER COMMISSION'S MOTION TO EXPEDITE PROCEEDINGS

Now come Continental Oil Company, Midhurst Oil Corporation,[1] The Superior Oil Company,[2] and Hunt Oil Company, Placid Oil Company, *et al.*,[3] Respondents in the captioned case, and respectfully submit this Brief in Opposition to the Federal Power Commission's Motion to Expedite Proceedings filed concurrently with the Commission's Petition for Writ of Certiorari in this cause.

[1] Continental Oil Company and Midhurst Oil Corporation are also Petitioners in Cause No. 1274, October Term, 1966, the first of the several petitions for writ of certiorari filed with this Court seeking review of the opinion of the Court of Appeals for the Tenth Circuit in the Permian Basin area rate cases.

[2] The Superior Oil Company is also Petitioner in Cause No. 1287, October Term, 1966, involving the same opinion below.

[3] Hunt Oil Company, Placid Oil Company, *et al.*, are also Petitioners in Cause No. 1294, October Term 1966, involving the same opinion below. The "*et al.*" entities indicated here are shown on the signature page of this brief.

We have no objection to the time at which this Court might choose to consider the presently pending petitions[4] involving the Permian Basin area rate case.[5] Our objections are directed to the second suggestion by the Commission, which relates to the scheduling and order of filing briefs on the merits and submission of the cases on oral argument.

The Commission suggests the following procedures:

1. That the Commission and other parties supporting the Commission's Opinion 468 below file initial briefs by August 25, 1967, and that the other parties, who oppose both the Commission's opinion below and the Court of Appeals' opinion insofar as it affirms the Commission's opinion, file briefs within thirty days thereafter, *i.e.*, September 25, 1967.

2. That the Commission and those parties supporting it open the oral argument, alloting four hours for the Commission and its supporters and four hours for all other parties.

We respectfully submit that the Commission, in effect, is proposing to subvert the ordinary procedures by which those complaining of the opinions below, the real petitioners in these cases, would have the right to submit opening and responsive briefs and open and close on oral argument. We also submit that the suggested period of only thirty days between briefs is woefully inadequate for submission of reply briefs. We further submit that the suggested time allotment

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[4] Oct. Term, Nos. 1274, 1287, 1291, 1292, 1293, 1294, 1295, 1302, 1342.

[5] Some 18 other parties have recently filed a motion to extend the time for filing briefs opposing all petitions for writ of certiorari involving the Permian case. The Court's disposition of this motion could be controlling for the time within which the pending petitions will be considered.

for oral argument is premature and inappropriate. For these reasons, we oppose the foregoing suggestions by the Commission and submit the following alternative suggestions, which are better intended to preserve procedural fairness for all parties and take account of the realities of the respective parties' positions in these cases.

We submit that briefs can be presented more fairly in these cases, where petitions have been filed on both sides, if the following procedures are adopted:

1. We propose that *simultaneous* initial briefs be filed by all petitioners, to be filed on such date as the Court might deem appropriate.

2. We propose that simultaneous reply briefs, by which each party would be afforded an opportunity to reply to his adversaries' contentions, be filed *sixty* days after the filing of initial briefs. Thus, if initial briefs were filed by all parties on August 25, 1967, simultaneous reply briefs would be filed by October 25, 1967. At least sixty days' time is required to afford the parties an opportunity to receive service by mail of the various initial briefs, prepare their reply to the numerous opposing briefs, and have the same printed and filed. This is particularly true with respect to the producer petitioners, who are located at great distances from Washington, D. C.

   In this respect, we also call the Court's attention to the fact that the Commission itself experienced the need, due to the complexities of this case, for a considerably extended briefing schedule in the Court of Appeals below and requested and obtained from that Court extensions of the briefing schedule which had initially been agreed upon by the parties. As a result of the extensions sought and obtained by the Commission itself in the court below, reply briefs were filed on May 9, 1966, by the Commis-

sion and its supporters; this was nearly one hundred days after the producers' initial briefs were filed on January 31, 1966.

3. We propose that those petitioners before this Court who oppose both the Commission's opinion below and the Court of Appeals' opinion insofar as it supports the Commission, open the oral argument. These petitioners, which include the undersigned producers, are the real petitioners in these cases. As shown by the petitions of the parties hereto, the producers seek a broad review of the underlying philosophy and economic rationale of area ratemaking. The petitioners in Causes 1274, 1287 and 1294, *inter alia*, challenge the fundamental premises of the Commission's and the Court of Appeals' area rate approach. The Commission's petition seeks a much more circumscribed review involving only the specific mechanics of a cost-based area rate approach approved by the court below.[6]

On balance, the producers who seek review of the Tenth Circuit's opinion, and the underlying Commission opinion, are in the considerably more significant position as petitioners than are the Commission and its supporters who all appear basically as respondents before this Court, supporting in its entirety the Commission's opinion and in very large measure supporting the opinion of the Court of Appeals below.

The producer petitioners, who thus have the significant role as complainants before this Court, should be accorded the opportunity to open on oral argument

[6] Case No. 1342, the Commission's petition, seeks review only on four limited elements of the cost of service approach, *i.e.*, rate of return, testing of costs with revenues, treatment of refunds and individual exemptions from area rates.

and to reply to the argument of the Commission and its supporters. In the alternative, the Court might provide for opening arguments by all parties and then permit separate closing arguments by all parties. Such closing arguments would be limited to responding to the adverse opening arguments made by opponents.

4. We submit that the Commission's request for an equal allotment of time for oral argument for each alleged "side" is premature at this point. The allotment of time for oral argument can best be made after all petitions for certiorari are before this Court and all briefs on the merits have been filed by the various parties. Positions will then be clearer, the total number of parties will be known, and the relative amounts of time which might be required by the parties can better be determined at that time. After briefing, the parties can be expected to limit their respective participations in oral argument more effectively in order to prevent duplication of argument. An allotment of time for oral argument could then be made.

Moreover, the suggested division of time is improper.[7] Equal time for argument as suggested by the Commission may prove inappropriate. The experience in the Court of Appeals below showed that a somewhat longer time was required for the petitioners there, who are on the producer side before this Court. This resulted in a division of time of over six hours

[7] The Commission oversimplifies dividing the parties into two sides, referring to those who support it and those who oppose it. Actually, even the undersigned producers do not represent one "side". We assert different positions in our petitions in Cause Nos. 1274, 1287 and 1294, particularly on fundamental questions such as the legality of area ratemaking. Other producers may support the Court below, but not the Commission. There are, thus, many "sides" in these cases.

for the producers compared to only four hours for the Commission and its supporters. This procedure was appropriate because of the greater number of produeer petitioners and the diversity and complexity of the producer positions. On the other hand, the Commission and its supporters, here as below, do represent essentially one position which avows simple and complete support of the Commission's opinion. The division of time for oral argument should then be left to later consideration, giving due regard to the foregoing considerations.

WHEREFORE, Continental Oil Company, Midhurst Oil Corporation, The Superior Oil Company, and Hunt Oil Company, Placid Oil Company, *et al.*, respectfully oppose the Commission's Motion to Expedite Proceedings insofar as the same relates to suggested scheduling, order and timing for filing briefs and submission of oral argument. We respectfully urge that the Court adopt instead the alternative procedures set forth above. These alternative procedures will most fairly and expeditiously advance the Court's consideration of this and related Permian Basin cases.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I, Bruce R. Merrill, certify that I have this 11th day of May, 1967, served copies of the foregoing brief in opposition to all parties in this cause and the related Cause Nos. 1274, 1287, 1291-1295, and 1302 by mailing the same postpaid, air mail to the counsel of record for such parties this day.

.....

Bruce R. Merrill

REPLY BRIEF FOR RESPONDENT

MAY 16 1967
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1966

No. 1342

FEDERAL POWER COMMISSION, *Petitioner*

v.

SKELLY OIL COMPANY, *et al.*
(Permian Basin Area Rate Case)

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

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May 15, 1967

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On Petition for a Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

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ANSWER OF INDICATED RESPONDENTS* TO "MOTION TO EXPEDITE PROCEEDINGS"

Respondents indicated below* hereby submit their answer to the "Motion to Expedite Proceedings" filed

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* Respondents to the petition in No. 1342 include 64 parties who were petitioners below. This Answer is submitted only on behalf of the Respondents whose names are listed *infra*. Such indicated Respondents request that this Answer also be deemed responsive to the "Motion to Expedite Proceedings" filed by Petitioners in No. 1295 on or about May 12, 1967, and to the similar motion filed by Petitioners in No. 1293 on or about the same date.

May 1, 1967 by the Solicitor General. These Respondents do not oppose the Solicitor General's objectives of orderly consideration of this and related cases, but show that.

(1) the proposed date of May 20, 1967 for the filing of briefs in opposition in this and related cases is unreasonably burdensome and practically impossible and that June 1, 1967 is the earliest feasible date;

(2) any schedule of proposed dates for the filing of briefs on the merits must allow at least 60 days for the filing of briefs by Respondents in this and related cases; and

(3) questions of allotment and division of time for oral argument must be deferred until after this Court acts on the ten or more pending related petitions, and if any or all are granted, counsel for all parties thereafter have opportunity to confer and submit, if possible, an agreed-upon proposal for allotment and division of time.

1. *Date for Filing Briefs in Opposition.* By order entered May 13, 1967 by Mr: Justice White after consulting with other members of the Court, we have been advised that briefs in opposition in this and related cases need not be filed prior to June 1, 1967.

June 1, 1967 is the earliest feasible date for such filing by these Respondents. As they did below, these Respondents intend to cooperate with all parties in reducing the number of briefs and pleadings despite the complexity of issues and number of parties in these cases. However, it is physically impossible for this to be accomplished and to comply with the unreasonable

May 20, 1967 filing date proposed by the Solicitor General.

The petition on behalf of the Federal Power Commission was not filed until May 1, 1967 and was received by Respondents' counsel dispersed throughout the country at various dates thereafter. In addition, petitioners in related cases began on May 4, 1967 to supplement pending petitions as a result of entry by the court below of an order on rehearing on April 18, 1967. Consequently, there are not less than ten pending petitions, and supplements thereto, in these related cases, presenting not less than 42 separately stated questions which must be considered in briefs in opposition.

These Respondents have begun analysis of these questions, preparation of briefs in opposition, and planning for limiting the documents to be filed here. However, the complexity of issues, proliferation of petitions, supplements and issues, and geographic dispersal of Respondents' counsel, are obvious. The process of coordination, looking toward one or a limited number of briefs in opposition to petitions and supplemental petitions, requires that Respondents' counsel be, in the interest of fairness alone, accorded more time than is suggested by the Solicitor General.

Under Mr. Justice White's order entered May 13, 1967, responses to the petition on behalf of the Federal Power Commission are not required to be filed until June 1, 1967. Responses to supplemental petitions are not required to be filed until as late as June 7, 1967. Beyond this, three parties opposing these Respondents below who have obtained extensions of time to June 19, 1967 for the filing of their petitions in this Court have not yet filed to our knowledge.

These Respondents, therefore, oppose the Motion of the Solicitor General insofar as May 20, 1967 is suggested as a deadline for filing briefs in opposition. These Respondents do not believe the Court can properly assume that all petitions and supplemental petitions will be granted, or that all of the 42 or more questions posed by Petitioners are properly here or ripe for review by this Court.[1] Briefs in opposition by Respondents in this and related cases therefore are essential to any orderly sifting and consideration of the questions presented. We should be afforded a realistic opportunity to present our position in opposition to the petitions and the reasons therefor, before the Court acts on any of the petitions. Yet, as a practical matter, the date proposed by the Solicitor General would impose impossibilities of performance upon these Respondents, prejudicial to presentation of their position on the petitions to be considered by the Court.

The Solicitor General has referred to the importance of these cases and their complexity. We agree that such arguments must be considered, with others, in passing upon the pending petitions. We submit that without briefs in opposition to the petitions, including the supplemental petitions filed after the Solicitor General's Motion, there thus can be no fair, orderly, or adequate consideration of the petitions. For these

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[1] For example, the Supplemental Petition in No. 1293 seeks to interject a question admittedly never presented to or considered by the Court below in these cases and which actually was raised subsequently in a wholly separate administrative proceeding, on a totally distinct record, and fully briefed, argued, and decided at later dates in the Court of Appeals in a separate group of cases. (Phillips Petroleum Company v. Federal Power Commission, Nos. 8723, *et al.*, 10th Circuit, decided April 18, 1967).

reasons, we submit that the date already allowed by the Court—June 1, 1967—is the earliest practicable date for the filing of briefs in opposition.

2. *Briefs on the Merits.* Discussion of dates for the filing of briefs on the merits prior to the Court's action on the petitions is premature. However, in responding to the Solicitor General's Motion, we must assume that if the Court grants one or more of the petitions, such dates may be fixed by the Court at the same time. Therefore, these Respondents object now to any proposal that briefs of Respondents on the merits be filed within thirty (30) days after briefs on the merits on behalf of the Federal Power Commission and other Petitioners supporting its position.

A minimum of sixty (60) days must be allowed for the filing of briefs for respondents, regardless of which date is fixed for the filing of briefs by the Federal Power Commission and other Petitioners.

Because of the present posture of Petitioners and Respondents and possible later alignment or re-alignment of parties, we believe present Petitioners, other than the Federal Power Commission may submit alternative proposals in their answers to the Solicitor General's proposal (*e.g.*, that all parties file simultaneous opening briefs to be followed sixty (60) days later by simultaneous opposing briefs, or that all petitioners, regardless of alignment, file opening briefs on a fixed date to be followed sixty (60) days later by all respondents' briefs).

Regardless of such plans, proposals, and alignments, a period of sixty (60) days should be allowed for responsive briefs.

Experience has already shown that a period of only thirty (30) days for filing of responsive briefs is wholly insufficient in these cases because of the complex, numerous issues, number and diversity of parties, and number of opening briefs filed. Below, all parties cooperated in presenting to the court a briefing schedule initially allowing the Federal Power Commission and its supporters six (6) weeks to prepare and file their responsive briefs. However, after receipt of opening briefs, the Federal Power Commission itself found that even this time was insufficient, and, without objection, the court granted the Federal Power Commission's motion to enlarge this time to what was a total of not less than thirteen (13) weeks. At no point in the entire briefing process below did any party—including the Federal Power Commission—ever suggest that a period of only thirty (30) days could suffice for preparation and filing of responsive briefs. It thus is inevitable that if such an overly optimistic schedule is fixed here, at later points in time, this Court will be confronted with numerous, meritorious motions to enlarge time, possibly including, as below, such a motion on behalf of the Federal Power Commission.

These Respondents in particular will be unable rationally to comply with the schedule proposed. Before the Commission and the Court below, these Respondents have cooperated in presenting, to the extent possible, joint briefs, thus limiting number and length of documents before the forum. This process requires more time for coordination than would be required for a proliferation of single briefs. Here, these Respondents anticipate a similar effort, but that at least sixty (60) days—not a mere thirty—would be required, par-

ticularly since these Respondents would be answering the opening briefs of numerous opposing parties.

Allowance of sixty days to Respondents' counsel should not unduly delay the Solicitor General's timetable which contemplates a period of more than ten (10) weeks for preparation of the Federal Power Commission's brief. Respondents should be allowed at least eight (8) weeks thereafter. Objectives of expedition thus still could be served, but with fairness to all parties.

3. *Allotment and Division of Oral Argument Time.* Consideration of this part of the Solicitor General's Motion should be deferred until after the Court acts on petitions, after briefs on the merits are filed, and after counsel for all parties, including the Federal Power Commission, have been afforded opportunity to confer as to possible agreement on proposed allotment and division of time.

At this date, oral argument can only be the subject of speculative opposition by various petitioners not aligned with the Federal Power Commission and parties presently respondents in some, but not all, of the pending related cases. At a later date, such controversies may be removed by reasonable agreement among all parties.

CONCLUSION

For the reasons stated, these Respondents urge the Court

(1). to deny the Solicitor General's Motion to fix May 20, 1967 as a deadline for filing briefs in opposition to the petitions for a writ of certiorari, particularly because the Court's order entered May 13, 1967, now allows Respondents the date of June 1, 1967 in this and the related cases;

(2) in fixing any schedules for briefing on the merits, to allow at least sixty (60) days for the filing of briefs by parties responding to the briefs on behalf of the Federal Power Commission and parties supporting its position; and

(3) to deny the Solicitor General's Motion insofar as it is addressed to allotment and division of oral argument time without prejudice to resubmittal in the 1967 Term.

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May 15, 1967

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In the Supreme Court of the United States

OCTOBER TERM, 1967

FEDERAL POWER COMMISSION, PETITIONER

v.

SKELLY OIL COMPANY, ET AL. ("PERMIAN BASIN AREA RATE CASE")

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

SUPPLEMENT TO MOTION TO EXPEDITE PROCEEDINGS

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Washington, D.C. 20530.

In the Supreme Court of the United States

OCTOBER TERM, 1966

No. 1342

FEDERAL POWER COMMISSION, PETITIONER

v.

SKELLY OIL COMPANY, ET AL. ("PERMIAN BASIN AREA RATE CASE")

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

SUPPLEMENT TO MOTION TO EXPEDITE PROCEEDINGS

On May 1, 1967, the Solicitor General, on behalf of the Federal Power Commission, moved that the Court expedite the proceedings in this and the related dockets comprising the Permian Basin Area Rate Case (1) by granting the pending petitions for certiorari promptly after the filing of responding briefs on May 20, 1967; (2) by directing that briefs on the merits by all parties supporting the Commission's order be filed by August 25, 1967, and by those opposing by September 25, 1967; and (3) by allotting four hours of oral argument to each side, the parties filing their briefs on August 25 to open. Several petitioners have filed answers to this motion. And on

May 13, 1967, Mr. Justice White, after consulting with the other members of the Court, extended the time for responding to the petitions for certiorari to June 1, 1967. In the light of these developments, we deem it appropriate to restate and, in certain particulars, to modify our proposal.

1. We continue to believe that the Court can and should act on the petitions for certiorari this Term, so as to facilitate early argument and decision. We do not understand any of the parties to dissent from this aspect of the government's proposal. The petitions will clearly be ripe for disposition after June 1, when responses are due.

To be sure, additional petitions may be filed later, but that is no reason to delay acting on those which have already been filed and scheduling the briefing and argument of the case. Every significant question tendered to the court of appeals, and accordingly open to consideration by this Court, has been presented in the petitions already filed. All of the parties in the court of appeals are parties here, whether or not they file petitions. A party who does not file a petition in time for disposition this Term can nonetheless file a brief on the merits, as a respondent, presenting any issue he would tender in a petition, in accordance with the suggested schedule.

2. The parties supporting the Commission's order should file their briefs at one time and the parties opposing the order at another time. This seems to us essential if there is to be simplification in the presentation of the issues that this uniquely complex case raises. A more debatable question is which side should

file its briefs first and open oral argument. Since the ultimate issue is the validity of the Commission's order, which the Tenth Circuit set aside, those defending it bear the primary responsibility for explaining its operation and rationale and placing it in its economic and regulatory setting. Hence, our suggestion that they should open on brief and argument. The fact that the opponents of the order acknowledge considerable divergency of position among themselves supports this approach. We certainly do not view the order of briefing and argument as conferring any procedural or other advantage on either side.

We have no objection to allowing more than the conventional period of 30 days for filing answering briefs, in view of the number and complexity of the issues. We suggest that 45 days would appear adequate and would permit an early argument in the Fall.

3. Some of the petitioners have suggested that those opposing the Commission's order should be allowed more time in oral argument than its defenders because their attack on the decision of the court of appeals is more sweeping. This is no reason to depart from the Court's settled principle of granting equal time to both sides, since, obviously, those defending the Commission's order have not only to argue their differences with the court of appeals but also to answer the producers' arguments for reversal.

To recapitulate: we urge the Court to

(1) Grant the pending petitions for certiorari promptly after responding briefs are filed on June 1, 1967.

(2) Direct that all parties—including those who may file petitions for certiorari too late for disposition this Term—file their briefs on the merits on or before August 25, 1967, if they support the Commission's order, and within 45 days thereafter if they oppose it.

(3) Allot four hours of oral argument to each side, with the parties supporting the Commission's order to open and with the division of time among the parties on each side to be worked out by counsel.

Respectfully submitted.

THURGOOD MARSHALL,
Solicitor General.

MAY 1967.

U.S. GOVERNMENT PRINTING OFFICE: 1967

MEMORANDUM BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

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IN THE

Supreme Court of the United States

OCTOBER TERM 1966

NOS. ~~1342~~ 112 ET AL

FEDERAL POWER COMMISSION ET AL

v.

SKELLY OIL COMPANY ET AL

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IN THE

Supreme Court of the United States

OCTOBER TERM 1966

NOS. 1342 ET AL

FEDERAL POWER COMMISSION ET AL

v.

SKELLY OIL COMPANY ET AL

MEMORANDUM BRIEF IN OPPOSITION TO PETITIONS FOR CERTIORARI

To the Honorable Supreme Court of the United States:

Respondents, Perry R. Bass *et al* (Bass), file this memorandum brief in opposition to the petitions for writ of certiorari filed by the Federal Power Commission in No. 1342 and by other parties[1] to the proceedings before the United States Court of Appeals for the Tenth Circuit. Bass has filed a conditional petition in No. 1302 recommending that certiorari be denied, but requesting that in the event the Court should grant any other petition it should also grant certiorari as to the questions raised by Bass's petition. The reasons urged herein for denial of certiorari, while addressed specifically to the petition filed by the Federal Power Commission, are also applicable to the petitions filed by other parties.

QUESTIONS PRESENTED

The Federal Power Commission fixed maximum and minimum just and reasonable rates for gas produced from the

[1] Petitions on file in Nos. 1274, 1287, 1291, 1292, 1293, 1294, 1295 and 1302.

Permian Basin area of West Texas and New Mexico. The Commission provided that these area rates would be reduced by the cost of processing gas which did not meet prescribed quality standards. The court below sustained the Commission with respect to the basic issues raised by Bass and other producers. However, it remanded the case for further findings by the Commission "because the financial impact of the quality deductions is not ascertainable from the record" and therefore it was impossible to determine "whether the proper revenue requirements of the area producers as a group can be satisfied with rates having the ceiling and floor which the Commission has fixed." The court below also noted that the Commission had failed to provide adequate guidelines to be followed by producers in seeking exemption from the area rates and, on rehearing, held that "no refund obligation may be imposed for a period in which there is a group revenue deficiency."[2] Thus, three questions are presented for review:

1. Whether the court below erred in concluding that the lack of evidence as to the financial impact of the quality deductions makes it impossible to determine whether the area rates prescribed by the Commission meet the just and reasonable standard of sections 4 and 5 of the Natural Gas Act.[3]

2. Whether the court below erred in holding that no obligation to refund amounts collected in excess of the prescribed area rates may be imposed on area producers as a group unless and until it is shown that "group revenues exceed group revenue requirements."

---

[2] The court below also mentioned certain other technical defects, such as the Commission's failure to explain adequately its BTU (heat content) quality standard and the lack of notice that quality standards were at issue. The court assumed that these defects would be cured in the remanded proceedings.

[3] 15 U.S.C. § 717c, 717d.

3. Whether the court below erred in holding that the Commission's special exemption provisions "are so vague and nebulous that neither they [the producers] nor a court can determine what relief is being granted."

These questions do not justify the granting of certiorari. They do not concern any of the fundamental issues pertaining to the area rate method adopted by the Commission. Instead, this Court is called upon to review issues concerning the technical and mechanical application of this area rate method. These issues arise primarily from a lack of evidence to show the financial impact of the reduction in area rates resulting from the quality deductions required by the Commission. This lack of evidence — which was conceded by the Commission in the court below[4] — makes review by this Court premature.

REASONS FOR DENYING THE WRIT

1. Remand Is Necessary To Fill an Evidentiary Gap

With the blessing of this Court in its second *Phillips* decision,[5] the Federal Power Commission undertook the task of fixing just and reasonable rates for producers of natural gas on an area or group basis. The first area chosen for the implementation of area rates was the Permian Basin of West Texas and New Mexico. After extensive hearings, the Commission established area rates based upon its determination of the average cost of gas produced by a group of producers during 1960.[6]

---

[4] As pointed out by the court below:
"The Commission says in its brief that appropriate price differentials or adjustments could not be made on the basis of the record."

[5] *Wisconsin* v. *FPC*, 373 U.S. 294 (1963).

[6] The Commission established two prices: 16.5¢ per thousand cubic feet for gas-well gas sold under contracts dated January 1, 1961, and thereafter and 14.5¢ per thousand cubic feet for all gas sold under contracts executed before that date.

The Commission provided that its area rates should be reduced by the cost of processing gas to meet standards which the Commission simultaneously promulgated.[7] However, the Commission did not specify the amount of such quality deductions because the record did not contain evidence as to the cost of processing gas to bring it up to the prescribed standards,[8] and therefore the financial impact of such quality deductions was not ascertainable from the record.

The court below held that this evidentiary gap made it impossible to determine whether the area rates set by the Commission are just and reasonable within sections 4 and 5 of the Natural Gas Act. The court recognized this fatal flaw in the Commission's decision stating:

> "We believe that the controlling question is whether the proper revenue requirements of the area producers as a group can be satisfied with rates having the ceiling and the floor which the Commission has fixed. This cannot be answered because the financial impact of the quality deductions is not ascertainable from the record.
>
> • • •
>
> "We believe that under Hope, and under Second Phillips, the area producers, as a group, are entitled to

[7] Approximately 90% of the gas flowing in the Permian Basin did not meet the standards promulgated by the Commission. In its petition in No. 1302 Bass has raised a question concerning the promulgation of these quality standards without notice. The court below deferred passing on this question, assuming that the alleged lack of procedural due process would be cured by the remanded proceedings.

[8] In this connection the court below stated:
"The amount of the rate adjustments does not appear in the record because there was no evidence of the extent of quality differentials or of the processing costs of bringing the gas up to standards.

• • •

"The difficulty is that the record does not disclose the amount of deductions."

> recover their present operating expenses and capital costs with a return commensurate to the risk and sufficient to attract capital. Satisfaction of this requirement must appear through appropriate findings based on substantial evidence. These cannot be made on the record presented."

Thus, it is clear that the court below was not passing on the validity of the area rates set by the Commission; it simply pointed out that it could not determine whether such area rates were just and reasonable on the basis of the incomplete record presented for review.

The Commission attempts to avoid this evidentiary gap by arguing that the court below has attempted to substitute the "end result test" in lieu of the "fair relationship test" used by the Commission.[9] (Pet. 18-19) The Commission asserts that it was error to reject the "fair relationship" standard, citing *FPC* v. *Hope Natural Gas Co.*, 320 U.S. 591, where this Court recognized that "the Commission [is] not bound to the use of any single formula or combination of formulae in determining rates."

However, this semantical debate as to the applicability of the "end result" test or the "fair relationship" test is completely meaningless and irrelevant to the fundamental error in the orders under review. Because of the lack of evidence as to the financial impact of the quality deductions, neither test can be satisfied. Thus, the court below pointed out that the lack of evidence prevented application of the "end result" test, stating:

> "We do not know the producers' costs or revenue requirements. We do not know the economic factors

[9] In the orders under review the Commission stated:
"We are convinced that the record fully justifies the Commission's judgment that the ceiling prices we have fixed 'provide a fair relationship between the aggregate prices the consumer pays and the aggregate costs that producers incur' in the Permian Basin."

> which either require or permit departure from costs, and revenues. The end result test is not satisfied by a reliance on unknowns."

Likewise, the court recognized that the "fair relationship" test could not be applied, stating:

> "The facts sustaining the conclusion of fair relationship must be found. The Commission did not make those findings and indeed it could not have done so because of the failure of the record to disclose the revenue impact of the adjustments in area rates to reflect quality differentials."

In other words, the court made it crystal clear that it is the lack of evidence, not the formula used by the Commission, which requires that the subject orders be remanded.

This lack of evidence — admitted by the Commission in the court below[10] — shows why review by this Court at the present time is premature. The Commission concedes that the "record did not permit an estimate to be made of the specific cost of removing specific impurities," but argues that the court below overlooked evidence showing that on the average the cost deductions would be within a range of .7¢ to 1.5¢ per Mcf (Pet. 19-20). However, the court did not overlook such a showing in the record, but, after examining the record, specifically found that:

> "The amount of rate adjustments does not appear in the record because there was no evidence of the extent of quality differentials or of the processing cost of bringing the gas up to standard."

Only after the Commission has had an opportunity to comply with the mandate of the court below and "determine the effect of the quality adjustments and . . . determine

---

[10] See Footnote 4, *supra*.

the group revenues and revenue requirements" will this Court be in a position to realistically and intelligently determine the validity of the Commission's area rate determinations. The same is true with respect to the Commission's requirement that refunds be ordered for past "locked-in" periods. Under the rationale of this Court's second *Phillips* decision, 373 U.S. 294, it is impossible to determine whether refunds should be required until it has been determined whether producers, as a group, collected excess revenues during such "locked-in" periods.[11]

Again Bass would emphasize that the court below did not hold that the area rates prescribed by the Commission are unlawful; nor did it upset any of the Commission's calculations or impugn the method by which area prices were implemented. The court simply held that it could not properly review the area rates prescribed by the Commission under the end-result test, the fair relationship test or any other test until the financial impact of the quality deductions had been determined.

2. Remand Will Not Delay Other Area Rate Proceedings

The Commission urges that certiorari should be granted because "of the obvious desirability of winding up this first area proceeding at the earliest possible date" and emphasizes that "the future employment of this method for regulating rates of thousands of independent natural gas producers throughout the country" is involved (Pet. p. 18). Certainly Bass agrees with the desirability of concluding this area rate proceeding as soon as possible. However, review by this Court cannot cure the lack of evidence pointed out by the court below. Moreover, it is clear that

[11] Similarly, this Court is in no position to pass on the validity of the provision for special exemptions from area rates until the Commission has had an opportunity to supply the guidelines necessary to enable producers and a reviewing court to tell what relief is granted by such provision.

the argument that remand will delay other area rate proceedings is nothing but a strawman. The court below upheld the Commission on the basic issues presented for review by Bass and others. It upheld the use of the area rate method, the propriety of the Permian Basin as a rate area, the cost caluculations of the Commission, the rate of return used by the Commission, the Commission's two-price system for "new" and "old" gas, etc. It rejected contentions that Commissioners Black and Swidler were disqualified or that the Commission had inadequately considered the interests of the states of Texas and New Mexico. In short, the decision rendered by the court below, affirming the Commission in practically all important respects, provides satisfactory guidelines to be followed in regulating the remaining gas producing areas in the country. Presumably in those other area rate proceedings the Commission will fill the evidential gap which required a remand in this case.

CONCLUSION

For the foregoing reasons, the Petition for Writ of Certiorari filed by the Federal Power Commission and the petitions filed by all other parties should be denied.

Respectfully submitted,

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May 30, 1967

REPLY BRIEF FOR RESPONDENT

SUPREME COURT, U. S.

No. 1342

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1967

FEDERAL POWER COMMISSION, *Petitioner*

v.

SKELLY OIL COMPANY, *et al.*
("Permian Basin Area Rate Case")

On Petition for Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

Answer of Indicated Respondents to "Supplement to Motion to Expedite Proceedings"

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June 7, 1967

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1966

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Answer of Indicated Respondents to "Supplement to Motion to Expedite Proceedings"

Respondents indicated below submit this answer to the "Supplement to Motion to Expedite Proceedings," filed by the Solicitor General on May 29, 1967. Respondents do not disagree with the Solicitor General's objectives of orderly disposition of all pending peti-

tions for writs of certiorari in this and related cases (Nos. 1274, *et al.*). In all other respects, Respondents do oppose the "Supplement to Motion to Expedite Proceedings":

1. It is Respondents' position that review of these cases by this Court at this time would be premature, and that analysis of the pending petitions will reflect that interlocutory, advisory review is now sought. The Solicitor General nevertheless obscures the vital question of prematurity by assuming that all of the pending petitions will be granted and prematurely forcing attention of all parties and the Court upon procedural questions respecting briefing and argument. However, if this Court should grant any or all of the pending petitions, there will be sufficient time thereafter for all counsel to agree upon a fair briefing and argument schedule without embroiling the Court in present debate traceable, at least in part, to the prematurity of procedural questions.

2. Although denying that the order of briefing and argument now sought is viewed as "conferring any procedural or other advantage on either side,"[1] the Government's motion and supplement are devoted largely to the seeking of advantage.

The device employed is simple. The Government would ignore entirely the fact that all of the pending petitions, including that of the Commission, charge various errors committed by the court below. Thus, the Government says the "ultimate issue is the validity of the Commission's order."[2] From this springboard,

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[1] "Supplement to Motion to Expedite Proceedings," p. 3.

[2] *Ibid.*

the Government then seeks realignment here of parties, with those "supporting" the Commission's order on the one side, and those "opposing" on the other.[3] However, no reason is advanced for the suggested departure from normal, orderly procedures and such proposed realignment of the parties here. This case is not a *de novo* review of the agency order in this Court —the review here obviously is of the decision of the Court of Appeals.

We thus perceive no significant difference between these pending proceedings and any other case before this Court where there are multiple petitions seeking review of various aspects of a decision by a court below which remands a case for further administrative action by a federal regulatory agency. In this instance, petitioners attacking the Court of Appeals decision are, and should remain, one "side" for purposes of allotting time for oral argument, and all respondents not attacking, but defending, the Court of Appeals decision are, and should remain, the other.

3. To repeat, we recognize desirability of timely ruling upon pending petitions, but we object to the Solicitor General's proposed realignment of parties and the consequent unsupported and unsupportable departure from traditional procedures of this Court.

---

[3] The Solicitor General thus would realign with Respondents defending the Court of Appeals decision, the attacking Petitioners in Nos. 1274, 1287, 1291, 1292, 1294, and 1302. Essentially, however, the two "sides" before this Court are (1) all petitioners, including the Commission, attacking the court below, and (2) respondents defending the court below. If eight (8) hours are allotted for oral argument in this case, four (4) thus should be allotted to petitioners and four (4) to respondents defending the decision of the court below.

The suggested realignment could mean only that (1) the Commission, alone among petitioners, would be permitted to make an opening argument, and (2) arguments of respondents would be confusedly intermingled with arguments of all other petitioners. There is no reason to substitute such a novel "direct" review of the agency decision for the required review of a court of appeals decision; these Respondents should be afforded opportunity to respond in brief and argument to *all* petitioners attacking the decision of the Court of Appeals, an opportunity foreclosed by the realignment procedures suggested by the Solicitor General; arguments of petitioners and respondents should not be intermingled and confused as suggested; petitioners, whatever their status below, should open and close; and respondents who are not petitioners must be allowed to respond to all who are petitioners.

For these reasons, we have opposed and continue to oppose these premature, threshold efforts to freeze the Court and all parties into procedures inappropriate to the posture of the case and for responding parties who are not also petitioners.[4]

WHEREFORE, for all of the foregoing reasons and those previously set forth, these Respondents urge that the Solicitor General's suggestions for realignment of parties be denied, and that the "Supplement to Motion to Expedite Proceedings," as well as the portions of

[4] We, of course, do note that the Government has receded from its original position that only thirty (30) days would suffice to respond to briefs on the merits in these cases, and proposes, at least at this juncture, that the Court allow forty-five (45) days. As we have pointed out, however, at least sixty (60) days would be required, particularly because premature review is sought of many issues not reviewed on the merits by the Court of Appeals.

the original "Motion to Expedite Proceedings" still pending, be denied without prejudice to appropriate, timely renewal if any or all of the pending petitions seeking interlocutory review in this and the related cases should be granted.

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PETITION FOR A WRIT OF CERTIORARI

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1966

No. [redacted]181

THE CITY OF LOS ANGELES, a municipal corporation,

Petitioner,

vs.

SKELLY OIL COMPANY, et al.,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

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THE CITY OF LOS ANGELES, a municipal corporation,

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SKELLY OIL COMPANY, et al.,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

The Petitioner, The City of Los Angeles, respectfully prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Tenth Circuit entered on January 20, 1967.[1]

OPINIONS BELOW

The opinion of the Court of Appeals (Cal.Pet.App. 382-431)[2] and its opinion on rehearing (App. A, *infra*,

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[1] Petitioner was intervenor in support of the Federal Power Commission, respondent in the court below. Respondents on this petition for a writ of certiorari were the petitioners in the court below.

[2] "Cal. Pet. App." refers to the separate appendix filed in this Court by the State of California with its petition (No. 1293).

pp. 1-3) are not yet reported. The opinions and orders of the Federal Power Commission (J.A. 516d-826d, 827d-838d, 37s, 1105d-1132d, and 1133d-1136d;[3] Cal.Pet.App. 1-381) are reported at 34 F.P.C. 159, 418, 424, 1068, and 1082. The opinion of the hearing examiner (J.A. 97d-364d) is reported at 34 F.P.C. 306.

JURISDICTION

The judgments of the court of appeals were entered on January 20, 1967 and were modified by an order on rehearing entered on April 18, 1967 (App. A, *infra*, pp. 1-3). On April 17, 1967, Mr. Justice White extended the time for filing a petition for a writ of certiorari on behalf of The City of Los Angeles to June 19, 1967. Jurisdiction of this Court is invoked under 28 U.S.C. 1254(1) and 15 U.S.C. 717r(b).

QUESTIONS PRESENTED

1. Must the Federal Power Commission, under the Natural Gas Act (15 U.S.C. 717, *et seq.*), establish area gas rates to allow recovery of the industry's "cost of service" when according to the Commission such a cost of service would include expense items substantially in excess of the actual cost of the gas subject to the rate order?

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[3] The Joint Appendix in the court of appeals consists of thirteen volumes paginated as follows: Volumes I-V, which contain only testimony, are paginated 1-1908. Volumes VI-VIII, which contain exhibits presented during the hearings, are paginated 1e-1146e. Volumes IX-XI, which contain pleadings, orders, and opinions, are paginated 1d-1157d. There are also two small volumes — a supplement paginated 1s-40s, and a table of contents for Volumes I-XI.

2. Whether in view of this Court's decision in *Mobile*[4] and in *Sierra*[5] the Federal Power Commission's rate order is unlawful because it did not abrogate all producer contracts with prices below the applicable area rates found by the Commission to be just and reasonable to permit all producers to recover such rates?

3. Whether the Federal Power Commission need, at this time, in an area rate case establish detailed administrative procedures for individual producer relief, including provisions for a stay of the entire general rate order?

4. Whether the Federal Power Commission's Opinion No. 468 is a lawful and enforceable order of the Commission?

STATUTE INVOLVED

The statutory provisions involved are Sections 4 (15 U.S.C. § 717c), 5 (15 U.S.C. §717d), and 19 (15 U.S.C. §717r) of the Natural Gas Act. They are printed in Appendix B hereto, p. 432.[6]

STATEMENT

This Court is already familiar with the background which led to the Federal Power Commission's first area rate decision, which has now been remanded by the Court of Appeals. It is recited in full in Mr. Justice Harlan's Opinion in *Wisconsin v. Federal Power Commission*, 373

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[4] United Gas Pipe Line Co. v. Mobile Gas Corp., 350 U.S. 332 (1956).

[5] Federal Power Com. v. Sierra Pacific 350 U.S. 348 (1956).

[6] The appropriate provisions of the Natural Gas Act have been printed and bound with the Opinions below.

U.S. 294, 295-302 (1963), hereafter referred to as *Second Phillips,* and the facts there set forth need not all be repeated here except to state that the Commission's decision had its genesis in *Phillips Petroleum Co. v. Wisconsin,* 347 U.S. 672 (1954).

This Court will recall that following the remand in *Phillips Petroleum Co., supra* (which charged the Commission with the duty to regulate rates charged by the natural gas producers), the Commission reinstated its investigation of Phillips Petroleum Company's natural gas rates; and following extensive hearings, briefs and arguments, concluded:

> ". . . that the individual company cost-of-service method, based on theories of original cost and prudent investment, was not a workable or desirable method for determining the rates of independent producers and that the 'ultimate solution' lay in what has come to be known as the area rate approach: 'the determination of fair prices for gas, based on reasonable financial requirements of the industry' for each of the various producing areas of the country."[7]

Following its decision in *Second Phillips, supra,* the Commission set down its first area rate case on December 23, 1960. It was to encompass an oil and gas producing area known as the Permian Basin which the Commission characterized as "one of the nation's great oil and gas provinces."[8] This Basin is located in southeastern New

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[7] Second Phillips, *supra,* 373 U.S. at 298-299.

[8] Opinion No. 468, p. 1 (J.A. 529d, R. 277567).

Mexico and western Texas. It forms the most important natural gas supply area for southern California.

Los Angeles' need for effective producer regulation is unusually great. Its population of over 2½ million represents nearly one-half of the 6 million population in the Los Angeles Metropolitan Area. It represents a substantial part of the State, which is the largest in the Union, having a current population in excess of 19 million. It depends on natural gas as the basic source of residential and industrial energy. Not only is gas used directly for space heating, water heating, air conditioning and cooking, but it provides in large measure the energy used for generating electricity. Unlike other areas of the Nation, coal is not an economical alternative to natural gas for Los Angeles energy requirements for space and water heating. Also, the use of coal is prohibited by air pollution regulations. The use of oil is likewise prohibited, to the extent that gas is available for industrial use. Los Angeles is vitally interested in the outcome of this proceeding because about 65 percent of its total natural gas supply comes from pipelines whose major source of natural gas is in the Permian Basin area. Physically, nearly all the gas involved in this proceeding flows westward to markets in California or smaller markets along the way. This supply of natural gas, its price and the stability of that price are of critical importance to Petitioner and its residents as natural gas consumers.

Actual hearings in the Permian proceeding commenced on October 11, 1961, and concluded on September 12, 1963. Two hundred fifty-one hearing days were involved, and the hearing transcript covers 30,020 pages. Three

hundred thirty-seven exhibits were introduced by the parties. The matter was then submitted to a hearing examiner of the Federal Power Commission who rendered his decision on September 17, 1964. Following briefs on exceptions, oral argument was heard by the full Commission beginning on February 8, 1965. On August 5, 1965, the Commission issued its opinion. Following petitions for rehearing, the Commission issued Opinion No. 468-A on October 4, 1965, denying applications for rehearing, but modifying its initial opinion where it deemed appropriate. Los Angeles participated extensively in the proceeding.

On September 13, 1965, Skelly Oil Company petitioned for review by the Court of Appeals for the Tenth Circuit, and other respondent producers followed suit. Los Angeles intervened and actively participated by brief. On January 20, 1967, the Court of Appeals issued its opinion remanding the Commission's decision for further proceeding in accordance with that opinion. On petition for rehearing by a number of respondent producers, the Court of Appeals issued its Opinion (App. A *infra* pp. 1-3).

REASONS FOR GRANTING THE WRIT

1. The Remand Ordered by the Court Below Would Result in Fruitless and Unnecessary Delay of Producer Regulation.

The Court of Appeals upheld the basic framework of the method of regulation adopted by the Commission. In doing so it approved the area method of regulation,

the two price system adopted by the Commission, the cutoff date proposed, and the moratorium on price increases, all essential to the effectiveness of the Commission's action. It nevertheless remanded to the Commission for further proceedings, the matters encompassed in our statement of questions presented.

Review by this Court is necessary to avoid such a remand, which will fruitlessly enlarge the delay already lasting 13 years in the Commission achieving the goal of this Court's mandate in *Phillips Petroleum Company, supra,* to effectively regulate producers rates. Indeed, the entire question of the proper regulation of producer prices under the Natural Gas Act must in any event ultimately reach this Court. The orderly administration of the Natural Gas Act and the imperative need for the earliest possible protection of the gas consumers would seem to require that the date for a definite decision from this Court be delayed no longer. *Atlantic Ref. Co. v. Public Serv. Com.,* 360 U.S. 378 (1959). The Commission has long struggled with the duty imposed upon it to regulate producer rates. The history of this struggle can be read in the decisions of this Court in the years since 1954 which have arisen from Commission action. And now, in this case, the Commission has come forward with the method of regulation which not only satisfies its conception of the requirements of the Natural Gas Act, but in large measure satisfies the requirements of the Court below.

The Commission's opinion opened with:

> "This is the first area proceeding to determine just and reasonable rates for natural gas producers. It

> is the culmination of an effort initiated more than four and a half years ago, and which has been carried forward with the greatest sense of urgency on the part of all concerned." 34 FPC at 171, J.A. 529d, R277, 568.

This sense of urgency was the result of the recognition by all concerned, including the Commission, that this case was the most important one to be heard by the Commission since it was impressed with the duty to regulate the rates of independent producers. The interim efforts of the Commission in attempting to fulfill this duty have been heard by this Court. This decision is of far greater importance than the interim decisions already heard, and it is, therefore, most certainly worthy of this Court's immediate consideration.

The effect of the Court's remand of the Commission's decision can best be described by the following quotation from this Court's opinion in *Second Phillips, supra.*

> "Such a remand undoubtedly would have consumed considerable time and energy, including that of the Commission and its staff, and would almost certainly have involved another decision by a hearing examiner, another appeal to the Commission, another petition for rehearing and further judicial review of complex and difficult issues. In short, the alternative rejected by the Commission would not have resulted in definitive regulation of Phillips' rates immediately or in the near future. Indeed, several years might have elapsed before even the method of regulation which the Commission regards as unsuitable

would have become effective as to even this one producer." (373 U.S. at 311-312)

On rehearing, the court held that its original approval of the Commission's refund ruling had been erroneous. It concluded instead that no refund obligation could be imposed for any period in which there was a "group revenue deficiency". "In fixing an area rate", it said, "the Commission must consider the effect which past and potential refunds have on the balancing of group revenues with group revenue requirements." (App. A, *infra*, p. 3.)

We urge this Court to immediately grant this writ of certiorari in order to completely review the *entire* decision so that the uncertainty in this important regulatory area can be brought to a prompt end. To not grant this writ before the end of the current term of the Court will delay ultimate resolution for another year. Continued delay will seriously hamper effective regulation.

2. The Rate Order Adopted by the Commission is Not Unlawful.

(a) There Has Been No Showing that the Commission's Rate Order Will Not Permit Revenues Adequate to Recover the Producers' Actual Cost of Gas Sold.

The Court below, in the absence of any showing that the actual cost of the gas being sold by the producers exceeded the allowed rates, either individually or as a group, concluded that the rate order was unlawful because the Commission did not specifically find that its

applicable rates, including quality adjustments, would recover the total "cost of service" of the producers as a group. The "cost of service" includes not only the cost of production but also the cost of finding new reserves and additional reserves to meet estimated future demands. The Commission in discussing these items of cost said in respect to the bulk of the gas subject to the rate order:

> "While the cost of residue gas cannot be found with the precision requisite to serve as a basis for fixing ceiling prices, the evidence in the record makes clear that with respect to casinghead gas and residue gas derived therefrom (which together make up by far the largest share of the Permian gas subject to quality adjustments) the costs are substantially below the 14.5 cents per Mcf ceiling price. For one thing the price includes a 4.08 cents allowance for exploration and development expense even though such gas was largely found as a by-product of the search for oil. For another, there would be no reason to allow producers a 12 percent rate of return on their investment for processing residue gas since the investment in processing plants and equipment is subject to few of the special risks incurred by those who explore for and develop reserves of gas.
>
> "We do not mean to suggest that the E&D allowance and the profit which we have provided for flowing gas is not fully justified, but we believe it is relevant to point out that these two items, which account for 9.0 cents of the 14.5 cents price for

> flowing gas, are based in part on justifications other than cost, and provide ample allowance for the risk that low-quality gas in the area may not command the full area price." (Opinion No. 468A, p. 6; J.A. 1112d-1113d, R278, 709-R278, 710)

The court below completely ignored the above finding and statement of the Commission and ignored its own following observation:

> "We agree with the Commission that the expense items included in an individual cost-of-service are not the measure of a confiscatory rate. A producer has no constitutional right to be reimbursed for dry-hole expenses. Also it has no obligation to remain in business by replenishing the supplies of gas which form the basis of present obligations. Inability to continue exploration and development is not confiscation. We conclude that the impact of the Permian rates on the high cost producers does not destroy the area rate method. (Appendix A, p. 416-417)

Not only has there been no showing of confiscation, but the record before the Commission and above quoted statement of the court below establishes that rates fixed on the basis of "cost of service" are above the actual costs of gas sold.

We do not mean to suggest, as the Commission in the above quotation did not mean to suggest, that it is either improper or not in the public interest to provide for an adequate exploration allowance to replace gas sold and obtain additional reserves. However, we do suggest that

the rates established by the rate order cannot be held to be unlawfully low merely because the Commission did not specifically find that such rates would permit the recovery of revenues adequate to cover a "cost of service" which, the Commission said, substantially exceeds the actual cost of the gas subject to the order.

The court below read *Hope* [(*Federal Power Comm'n v. Hope Nat. Gas Co.*, 320 U.S. 591 (1943)] as in effect requiring the Commission to find the cost of gas sold by producers as a group and provide rates to cover such costs. The conclusion of the Commission based on substantial evidence that its rates were above such costs was held to be insufficient. In so holding the court below overlooked the rule laid down long ago by this Court, that on judicial review appellate courts could not upset the rate order unless confiscation is clearly shown. [*Los Angeles G & E Co. v. Railroad Comm'n*, 289 U.S. 287 (1932); *Lindheimer v. Illinois Bell*, 292 U.S. 151 (1933).]

The court below also overlooked the very words of *Hope* itself that

> ". . . the Commission's order does not become suspect by reason of the fact that it is challenged. It is the product of expert judgment which carries a presumption of validity. And he who would upset the rate order under the Act carries the heavy burden of making a convincing showing that it is invalid because it is unjust and unreasonable in its consequences." 320 U.S. at 602 (citations omitted)

This principle was reapproved by this Court in *Second Phillips, supra,* which involved the precise subject here at issue — ratemaking on an area basis. 373 U.S. at 309.

There was no showing that the rate order was confiscatory, there was no showing that the rate order was unjust and unreasonable in its consequences, and the Commission found precisely to the contrary on substantial record evidence.

It is our view that the Commission satisfied the *Hope* "end result" test; and indeed it is more than apparent that this was its goal in Opinion 468.

(b) The Court of Appeals' Decision Is Incompatible With This Court's Pronouncements in the *Sierra* and *Mobile* Cases.

The Court of Appeals' decision is in clear conflict with this Court's decisions in *Sierra*[9] and *Mobile*.[10] The Court of Appeals implies that in testing to determine whether the revenue requirement of the industry is being satisfied so as to meet the *Hope* test, the Commission must take into consideration and compensate for revenue deficiencies caused by contractual price restrictions the producers have contractually bound themselves to.

This Court, in *Sierra*, held that contractual obligations cannot be upset by a regulatory agency unless there is a finding that the public interest requires it. The Commission can increase the contract rate only when it is so low as to adversely affect the public interest.

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[9] Federal Power Com. v. Sierra Pacific, *supra.*

[10] United Gas Pipeline Co. v. Mobile Gas Corp., *supra.*

> "In such circumstances the sole concern of the Commission would seem to be whether the rate is so low as to adversely affect the public interest — as where it might impair the financial ability of the public utility to continue its service, cast upon other consumers an excessive burden, or be unduly discriminatory." 350 U.S. at 355.

The Commission's Opinion No. 468 found that the public interest did require a floor or minimum rate. It set this rate at 9 cents per Mcf. It did not find that the public interest required that the area rate be raised to compensate for low contractual commitments, nor did it find that rates in excess of 9 cents, but below the area ceiling, should be raised to the area ceiling to insure that revenues will balance costs. For the Commission to have done so would have been error, for there is no evidence in the record to sustain such a result. Nevertheless, the Court of Appeals implies that low rates must be raised to the area rate without the requisite finding that the contract rate is so low as to affect the public interest. This, we submit, misreads *Sierra* and *Mobile*. The Court of Appeals' holding should not be permitted to stand.

(c) The Court of Appeals' Suggestion Regarding the Savings Clause is Premature and Would Create Administrative Havoc.

Another error is the Court of Appeals' position on the savings clause — that clause which the Commission inserted in its decision to allow special relief when the public interest or constitutional considerations so required. The Court of Appeals found the Commission's provision "vague and nebulous." It said:

> "An adequate savings clause should contain guidelines which if followed by an aggrieved producer will permit it to be heard promptly and to have a stay of the general rate order until its claim for exemption is decided."[11]

It would be highly inappropriate to remand this important case for the purpose of establishing administrative procedures for savings clause relief. The lower court's concern regarding the detailed operation of the savings clause is premature. The appropriate time for judicial review of administrative procedures involving the savings clause would arise at such time as a producer seeks savings clause relief and is denied such relief as a result of procedural or substantive error on the part of the Commission. Further, the blanket mandatory "stay of the general order" suggested by the Court is judicially unique — traditionally, stays have been granted on the basis of the particular circumstances of each case. Adoption of the lower court's stay requirement would lead to administrative chaos completely frustrating effective area rate making.

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[11] Appendix B, page 419.

CONCLUSION

"[T]o afford consumers a complete, permanent and effective kind of protection from excessive rates and charges,"[12] which Congress promised and this Court affirmed, immediate action is needed by this Court. This petition for a writ of certiorari must be granted this term so that further delays — which are in our view harmful to the entire gas industry — will be prevented.

Respectfully presented,
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[12] Atlantic Ref. Co. v. Public Serv. Com., *supra*, 360 U.S. at 388.

APPENDIX

APPENDIX A

UNITED STATES COURT OF APPEALS

TENTH CIRCUIT

MARCH TERM, 1967
[April 18, 1967]

Nos. 8385 etc.

SKELLY OIL COMPANY, ET AL., PETITIONERS

v.

FEDERAL POWER COMMISSION, RESPONDENT

On rehearing.

Per Curiam.

Texaco Inc. asserts that the opinion is not clear as to the disposition of its Docket No. C161-879 in which, by an order separate and apart from Opinions Nos. 468 and 468-A and their accompanying orders, a § 7 certificate was issued at a rate of 14.5 cents less quality deductions. This separate order shows that the Commission treated the area rate as the in-line rate for § 7 certificates.

The order on this docket was lost in the mass of material presented to us. No party made a point of it. We have reconsidered the Texaco petition for review and have concluded that it is sufficiently broad to cover such order. It should receive the same treatment as the § 4 and § 5 proceedings. Accordingly, the remand includes the separate order entered in Docket No. C161-879.

We note that in its disposition of this particular docket the Commission took the position that an established area rate automatically becomes the in-line rate for a § 7 proceeding. The same position was taken by the Commission in its Opinion No. 484 which we are today reversing by our decision in Nos. 8723 etc. — Phillips Petroleum Company, et al. v. Federal Power Commission, —— F.2d ——. We there hold that in a § 7 application heard by the Commission after its Permian decision the adoption of the area rate as an in-line rate must fall because we have rejected the area rate. We do not there, and we do not here, express either approval or disapproval of the principle that an area rate established in a § 5 proceeding automatically becomes an in-line rate for a § 7 proceeding. The validity of such a principle may be affected by the final determination of the validity of the Permian Basin area rate.

Various producers insist that we erred in our treatment of refunds. We held that refunds must be on a company-by-company and schedule-by-schedule basis. We are now convinced that such holding was wrong and is inconsistent with our conclusion that satisfaction of the end result test requires rates which will equate group revenues with group revenue requirements.

The refunds in question relate to collections made during the so-called "locked-in" periods, i.e., the periods during which an increased rate, later superseded by a further increase, is effective. See Second Phillips, 373 U.S. 294, 298, fn. 5. In that case the Court said that on the locked-in rate issue "the sole question was whether all or any part of the increases had to be refunded by

Phillips." The Court pointed out that the Commission decided that the increases did not bring revenues up to cost of service, and held that the Commission "properly concluded" that "no refund obligations could be imposed." *Id.* at 306.

We are now convinced that this treatment of refund obligations for locked-in rates in the case of an individual company in Second Phillips must be applied on a group basis when an area rate is fixed and tested by the end result. We are also convinced that our reliance on Federal Power Commission v. Tennessee Gas Transmission Co., 371 U.S. 145, was misplaced. That case dealt with zone rates. The Second Phillips decision on locked-in rates came later.

This modification of the opinion means that no refund obligation may be imposed for a period in which there is a group revenue deficiency. When group revenues exceed group revenue requirements, refunds may be ordered on some equitable contract-by-contract basis. In fixing an area rate, the Commission must consider the effect which past and potential refunds have on the balancing of group revenues with group revenue requirements.

In all respects, except those specifically noted herein, the petitions for rehearing are severally denied.

PETITION FOR A WRIT OF CERTIORARI

OCTOBER TERM, 1967

No. 261

FILED

JUN 19 196

JOHN F. DAVIS, CLE

CITY AND COUNTY OF SAN FRANCISCO, a municipal corporation,
Petitioner,

vs.

SKELLY OIL COMPANY, PHILLIPS PETROLEUM COMPANY, WARREN PETROLEUM CORPORATION, MOBIL OIL CORPORATION (formerly SOCONY MOBIL OIL COMPANY, INC.), PAN AMERICAN PETROLEUM CORPORATION, NORTHERN NATURAL GAS PRODUCING COMPANY, STANDARD OIL COMPANY OF TEXAS, a Division of Chevron Oil Company, TEXACO INC., HUNT OIL COMPANY, jointly with H. L. HUNT, LAMAR HUNT, N. B. HUNT, W. H. HUNT, Secure Trusts, CAROLINE and LOYD B. SANDS, CAROLINE HUNT TRUST ESTATE, LYDA HUNT-CAROLINE TRUSTS, LYDA HUNT-BUNKER TRUSTS, LYDA HUNT-LAMAR TRUSTS, LYDA HUNT-HERBERT TRUSTS, LYDA HUNT-MARGARET TRUSTS (formerly Estate of Lyda Bunker Hunt, Deceased), HUNT INDUSTRIES (formerly Estate of Lyda Bunker Hunt, Deceased), and PLACID OIL COMPANY, HUMBLE OIL & REFINING COMPANY, SHELL OIL COMPANY, THE ATLANTIC RICHFIELD COMPANY (formerly The Atlantic Refining Company) jointly with Dorchester Gas Producing Company, Southland Royalty Company, and Westates Petroleum Company, CONTINENTAL OIL COMPANY jointly with Sunray DX Oil Company, Sinclair Oil & Gas Company, Cabot Corporation, Sohio Petroleum Company, Joseph E. Seagram & Sons, Inc., Joseph E. Seagram & Sons dba Texas Pacific Oil Company, Gulf Oil Corporation, Murphy Oil Corporation, The Nueces Company, Samedan Oil Corporation, Cities Service Oil Company (formerly Cities Service Petroleum Corporation), Cities Service Production Company (now merged with Cities Service Oil Company), Columbian Fuel Corporation, Amerada Petroleum Corporation, Union Oil Company of California and as successor to The Pure Oil Company, Tidewater Oil Company, Reef Corporation, and William A. & Edward R. Hudson, Joint Operators, MARATHON OIL COMPANY, SUN OIL COMPANY, INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA, THE BRITISH-AMERICAN OIL PRODUCING COMPANY, UNION TEXAS PETROLEUM, a Division of Allied Chemical Corporation, MIDHURST OIL CORPORATION, THE SUPERIOR OIL COMPANY, PERRY R. BASS jointly with Panther City Investment Co., Bass Bros. Enterprise, Inc., Perry R. Bass, Incorporated, and Richardson Oils, Inc., COLUMBIAN CARBON COMPANY jointly with Coltexo Corporation, THE STATE OF TEXAS, BIG CHIEF DRILLING COMPANY jointly with King-Stevenson Oil Co., Inc., and Service Drilling Company, TEXAS INDEPENDENT PRODUCERS & ROYALTY OWNERS ASSOCIATION jointly with West Central Texas Oil and Gas Association, STATE OF NEW MEXICO, GULF OIL CORPORATION, and J. C. BARNES, et al.,
Respondents.

PETITION FOR A WRIT OF CERTIORARI to the United States Court of Appeals for the Tenth Circuit.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1967

No. _____

CITY AND COUNTY OF SAN FRANCISCO, a municipal corporation,
Petitioner,

vs.

SKELLY OIL COMPANY, PHILLIPS PETROLEUM COMPANY, WARREN PETROLEUM CORPORATION, MOBIL OIL CORPORATION (formerly SOCONY MOBIL OIL COMPANY, INC.), PAN AMERICAN PETROLEUM CORPORATION, NORTHERN NATURAL GAS PRODUCING COMPANY, STANDARD OIL COMPANY OF TEXAS, a Division of Chevron Oil Company, TEXACO INC., HUNT OIL COMPANY, jointly with H. L. HUNT, LAMAR HUNT, N. B. HUNT, W. H. HUNT, Secure Trusts, CAROLINE and LOYD B. SANDS, CAROLINE HUNT TRUST ESTATE, LYDA HUNT-CAROLINE TRUSTS, LYDA HUNT-BUNKER TRUSTS, LYDA HUNT-LAMAR TRUSTS, LYDA HUNT-HERBERT TRUSTS, LYDA HUNT-MARGARET TRUSTS (formerly Estate of Lyda Bunker Hunt, Deceased), HUNT INDUSTRIES (formerly Estate of Lyda Bunker Hunt, Deceased), and PLACID OIL COMPANY, HUMBLE OIL & REFINING COMPANY, SHELL OIL COMPANY, THE ATLANTIC RICHFIELD COMPANY (formerly The Atlantic Refining Company) jointly with Dorchester Gas Producing Company, Southland Royalty Company, and Westates Petroleum Company, CONTINENTAL OIL COMPANY jointly with Sunray DX Oil Company, Sinclair Oil & Gas Company, Cabot Corporation, Sohio Petroleum Company, Joseph E. Seagram & Sons, Inc., Joseph E. Seagram & Sons dba Texas Pacific Oil Company, Gulf Oil Corporation, Murphy Oil Corporation, The Nueces Company, Samedan Oil Corporation, Cities Service Oil Company (formerly Cities Service Petroleum Corporation), Cities Service Production Company (now merged with Cities Service Oil Company), Columbian Fuel Corporation, Amerada Petroleum Corporation, Union Oil Company of California and as successor to The Pure Oil Company, Tidewater Oil Company, Reef Corporation, and William A. & Edward R. Hudson, Joint Operators, MARATHON OIL COMPANY, SUN OIL COMPANY, INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA, THE BRITISH-AMERICAN OIL PRODUCING COMPANY, UNION TEXAS PETROLEUM, a Division of Allied Chemical Corporation, MIDHURST OIL CORPORATION, THE SUPERIOR OIL COMPANY, PERRY R. BASS jointly with Panther City Investment Co., Bass Bros. Enterprise, Inc., Perry R. Bass, Incorporated, and Richardson Oils, Inc., COLUMBIAN CARBON COMPANY jointly with Coltexo Corporation, THE STATE OF TEXAS, BIG CHIEF DRILLING COMPANY jointly with King-Stevenson Oil Co., Inc., and Service Drilling Company, TEXAS INDEPENDENT PRODUCERS & ROYALTY OWNERS ASSOCIATION jointly with West Central Texas Oil and Gas Association, STATE OF NEW MEXICO, GULF OIL CORPORATION, and J. C. BARNES, et al.,
Respondents.

PETITION FOR A WRIT OF CERTIORARI

to the United States Court of Appeals for the Tenth Circuit.

The Petitioner, City and County of San Francisco respectfully prays that a Writ of Certiorari issue to review the judgments of the United States Court of Appeals for the Tenth Circuit, entered in this case on January 20, 1967.[1]

OPINIONS BELOW

The opinion of the Court of Appeals is not yet reported but is printed in Appendix A which is the separate appendix filed by the State of California with its petition. The Federal Power Commission's opinions and orders are reported at 34 F.P.C. 159, 418, and 424 respectively.[2] The opinion of the hearing examiner is reported at 34 F.P.C. 306.

JURISDICTION

The judgment of the Court of Appeals was entered on January 20, 1967 and an order on rehearing was entered on April 18, 1967. A number of respondents have filed petitions for rehearing before the Court of

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[1]Petitioner was an intervenor in support of the Federal Power Commission, respondent in the Court below.

[2]The Joint Appendix contains thirteen volumes which are paginated as follows: Volumes I through V which contain only testimony, are paginated 1-1908. Volumes VI through VIII, which contain exhibits presented during the hearings are paginated 1e-1146e. Volumes IX through XI, which contain pleadings, orders and opinions, are paginated 1d-1157d. There are also two small volumes—a supplement numbered 1s-40s, and a separate volume containing the table of contents for Volumes I through XI.

Appeals and these are pending at the present time. Mr. Justice White extended the time for this petitioner to file a petition for a writ of certiorari to June 19, 1967. The jurisdiction of this Court is invoked under the provisions of 28 U.S.C. 1254(1) and Section 19(b) of the Natural Gas Act.

QUESTIONS PRESENTED

1. In determining just and reasonable area rates under Sections 4 and 5 of the Natural Gas Act, must the Federal Power Commission in order to satisfy the "end result" test set forth in *Federal Power Commission v. Hope Natural Gas Company,* 320 U.S. 591, determine the allowable area cost of service for the gas produced in the area, including an allowance for exploration to meet future demand for gas, find that such cost of service constitutes the area revenue requirement, and establish rates which will recover such revenue requirement; or may it determine area rates which establish a fair relationship between the revenues derived from the rates required and the allowable area cost of service?

2. Where *Federal Power Commission v. Sierra Pacific Power Company,* 350 U.S. 348 (1956), holds that voluntarily made contract rates, which are below the Federal Power Commission's subsequently determined just and reasonable rates, are not required to be raised to the same level as the just and reasonable rates unless the public interest so necessitates, must the Commission raise these low contract rates for the

purpose of insuring that area revenues equal the Commission's determination of allowable area costs?

3. In establishing group ceiling rates applicable to pipeline quality gas, is the Commission's rate-of-return allowance of twelve percent adequate where specific recognition was given to the fact that lower quality gas commanding a lesser price might be found and where this possibility was treated as an additional risk?

4. Where the Federal Power Commission establishes just and reasonable area rates, and there is a possibility that some producers may require special relief from these rates, did the Commission err by establishing a special relief provision, which announces that such producers may petition for relief, but which does not specify detailed guidelines for such relief?

5. Is the Federal Power Commission's area rate decision so vague and unclear with regard to the establishment of the "Btu gap" in its Btu quality standard that clarification is required?

6. Where the Federal Power Commission has determined just and reasonable area rates under Sections 4 and 5 of the Natural Gas Act, may the Commission find that such area rates prospectively constitute the initial price for certificating sales in the area under Section 7 of the Act.

7. Where the Federal Power Commission has determined just and reasonable area rates, must area revenues exceed the allowable area cost of service

before refunds of contract rates collected subject to refund under Section 4 of the Act may be ordered?[3]

STATUTE INVOLVED

The relevant provisions of the Natural Gas Act, 52 Stat. 821, as amended, 15 U.S.C., Sections 717-717w, are set forth in the California Public Utilities Commission Appendix B. Also involved is Section 7, 15 U.S.C. Section 717f, in Supplemental Appendix C submitted by petitioner Public Utilities Commission of the State of California.

STATEMENT OF THE CASE

For the first time, in this proceeding, the Commission fixed just and reasonable rates for producers of natural gas on an area basis in the Permian Basin of West Texas and Southeastern New Mexico. Area rate making has long been a problem in regard to producer regulations.

The Commission selected the Permian Basin as the first area with respect to which just and reasonable producer rates would be determined by use of the area rate making technique. The Permian Basin forms the most important gas supply area for the petitioner.

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[3]If certiorari is granted this petitioner requests the right to argue two additional questions:

(1) Whether the Commission gave adequate notice that it would prescribe quality standards in this proceeding.

(2) Whether the area rates fixed by the Commission are just and reasonable within the meaning of the Natural Gas Act.

The City and County of San Francisco depends vitally on the gas supply from this area. The price and stability of such price is of enormous importance to the petitioner.

The proceedings commenced on October 11, 1961, and were concluded on September 12, 1963. Briefs were filed by the parties and the matter was submitted to the Examiner for an initial decision.

DECISION OF THE EXAMINER

The Examiner determined area ceiling rates for various types of gas. The fixing of prices for new and old gas has come to be known as the two price system.

The Examiner found that producers could direct, to some extent, their exploration activities in a search for either gas or oil. This meant that a price for new gas-well gas could serve the economic function of eliciting supplies of gas, because the price of oil would play no part in motivating the separately determined search for gas reservoirs. (Gas-well gas is gas produced from gas only and gas condensate reservoirs.) In accordance with this economic approach, the price for new gas-well gas would be based on higher current costs—as opposed to lower historical costs. Thus the rate fixed for new gas-well gas would be higher than the rate fixed for old gas-well gas. This higher rate could therefore serve as an incentive to producers to explore for gas reservoirs and to dedicate new supplies of gas to the interstate market.

In regard to the date of selecting old and new gas the Examiner selected December 23, 1960, the date the proceedings were instituted.

The Examiner's determination of an area ceiling price for new gas-well gas was the important decision. The estimated national current cost of finding and producing new gas-well gas, including return at twelve percent, was related to the Permian Basin area by the application of a value-based geographical discount. This resulted in an average area price. A "gold standard," which is the premium above the average price for superior quality and value, was added to the average price to obtain the area ceiling price.

The area ceiling price for new gas-well gas governed the area ceiling price for new residue gas, i.e. residue gas derived from new gas-well gas. Separate rates were also determined for new casinghead gas.

The area ceiling price for old gas-well gas was determined by "deflating" the cost based revenue standard for new gas-well gas. The area ceiling prices for old residue and old casinghead gas were, in turn, related to the old gas-well gas price in terms of relative value.

It should be noted that, although determining area ceiling rates by inclusion of a gold standard for superior quality and value, the Examiner nevertheless failed to provide for deductions from the ceiling price, where gas was of less than pipeline quality.

COMMISSION DECISION

Oral argument was heard and on August 5, 1965 the Commission issued its decision, Opinion 468.

The Commission adopted the two-price system and determined base area ceiling rates for new gas-well gas and old (flowing) gas.[4] The Commission selected January 1, 1961, as the date dividing new and flowing gas. Separate prices were not established for types of gas, i.e., gas-well gas, residue gas, and casinghead gas.

In determining the base area rate for new gas-well gas, the Commission utilized the estimated national current cost of finding and producing new gas-well gas, including return computed at a rate of twelve percent. The Commission rejected the use of a geographical discount and a gold standard premium.

In determining the base area ceiling price for flowing gas, the Commission relied upon the 1960 area historical cost of service, including a return of twelve percent, applicable to flowing gas-well gas. This cost was used as a yardstick for the pricing of flowing residue and all casinghead gas.

The base area ceiling rates were to apply to sales of pipeline quality gas. Downward adjustments from the base area rates were to be made for deviations from

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[4]These Permian Basin base area rates are: Texas, Including Production Taxes—New Gas-Well Gas* . . . 16.5 cents per Mcf., Flowing Gas . . . 14.5 cents per Mcf.; New Mexico, Production Taxes to be Added—New Gas-Well Gas* . . . 15.5 cents per Mcf., Flowing Gas . . . 13.5 cents per Mcf. *The ceiling price for new gas-well gas is applicable to residue gas derived from new gas-well gas.

Flowing gas includes all gas except new gas-well gas and residue gas derived therefrom.

the pipeline quality standards defined by the Commission for hydrogen sulphide, sulphur, carbon dioxide, water, and delivery pressure. Both a downward and an upward adjustment were prescribed to reflect quality differentials respecting Btu content. The Btu adjustment, either upward or downward, would apply only to the base area rates for new gas-well gas and residue gas derived therefrom. The rate resulting from the application of the quality adjustments became the applicable area rate for the particular sale in question.

A minimum base area rate of nine cents per Mcf for all gas subject to quality adjustments was prescribed.

Special treatment was provided for small producers, whom the Commission defined as producers with sales of less than 10 million Mcf of jurisdictional gas per year. They may receive small producer certificates which authorize all future small producer sales in the area at or below the applicable area ceiling rate. They will not have to obtain separate certificates for each sale, or file the normal annual reports required from large producers.

Provision was made by the Commission for an individual producer to obtain special relief from the imposition of the area rates where such a producer could make a proper showing justifying such treatment, but the Commission made clear that it would not allow this provision to become an escape clause to return to individual company rate making.

The Commission ordered a moratorium on the filing of rate increases above the applicable area rate until January 1, 1968.

With respect to Section 4(e) dockets consolidated in the proceedings, the Commission provided for refunds of increased rates collected subject to refund prior to September 1, 1965, in excess of the applicable area rates. Payment of these Section 4(e) refunds was stayed by the Commission pending judicial review of its decision. (J.A. 696d, 1123d.)

APPLICATIONS FOR HEARING

Numerous applications for rehearing were filed by the producers. Rehearing was also sought by petitioner. (J.A. 1002d-1026d.) On October 4, 1965, the Commission issued Opinion No. 468-A, denying all applications for rehearing. However, in response to objections made by producers, the Commission modified the quality standards prescribed in Opinion No. 468 by reducing the delivery pressure standard, and by applying the downward and upward Btu adjustments to flowing gas. It also dealt with the producers' contentions that jurisdictional revenues must equal jurisdictional costs.

THE PROCEEDING IN THE COURT BELOW

Pursuant to Section 19(b) of the Natural Gas Act, the producers, related producer associations, and the states of New Mexico and Texas, respondents herein,

filed in the Court of Appeals for the Tenth Circuit petitions to review Commission Opinions Nos. 468 and 468-A.

Petitioner intervened in these review proceedings and took the position that the Commission decision should be affirmed as a lawful exercise of the Commission's authority under Sections 4 and 5 of the Natural Gas Act to fix just and reasonable rates.

On January 20, 1966, the Court below stayed Opinions Nos. 468 and 468-A, with certain exceptions, until thirty days after its decision on the merits or until thirty days after the determination of any petition for rehearing.[5] On January 20, 1967 it rendered its decision remanding the proceedings to the Commission for further hearings. On February 1, 1967 the Commission moved for a stay of mandate and suggested the extension of the stay order. The Court below, on February 15, 1967, extended its stay order until thirty days after termination of the proceedings in this Court in the event that petitions for writ of certiorari are filed.[6]

The Court of Appeals affirmed the Commission's authority to adopt the area rate method of regulation.

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[5]The court below did not stay the provisions of the Commission's decision which require filing of rate reduction supplements, quality statements, and refund reports, but these filings are not to become operative until termination of the stay order. It also ordered the producers to set aside for possible refund all amounts collected subsequent to September 1, 1965, in excess of the rates determined to be just and reasonable.

[6]The court did not rule on the Commission's motion to stay mandate due to the pending petitions for rehearing. (Rule 31b, U.S. Court of Appeals for the Tenth Circuit.)

Furthermore, it unequivocally rejected the producers' contention that effective competition exists in the natural gas production industry. Instead, it concluded that the Natural Gas Act's standard of just and reasonable rates and *Federal Power Commission v. Hope Natural Gas Company,* 320 U.S. 591 (1944),[7] required consideration of costs and revenues and rejection of the producers' contract-based commodity value approach. However, the Court concluded that the Commission failed to comply fully with the legal requirements for rate making under the Natural Gas Act as determined in the *Hope* case and in *Wisconsin v. Federal Power Commission,* 373 U.S. 294 (1963).[8] It also concluded that certain other provisions in the Commission's opinions and orders were vague.

With regard to the question of compliance with the *Hope* and *Second Phillips* cases, the Court below held that the Commission had "rejected the end result test and adopted a fair relationship standard." (App. A, p. 411.) It could not ascertain from the Commission's decision the producers' revenue requirements, or the economic factors which permit departure from consideration of costs and revenues, and therefore it could not accept the Commission's determination that a "fair relationship" between costs and revenues was sufficient to comply with the "end result" test. It took the position that under the end result test costs and revenues must balance:

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[7]Hereinafter referred to as *Hope.*

[8]Hereinafter referred to as *Second Phillips.*

> "Nothing in Second Phillips rejects the end result test of Hope. We believe that it applies here and that it is not satisfied by a finding of fair relationship. . .
>
> "From the standpoint of the producer the situation is different. It is entitled to recover its prudent operating expenses and capital costs with a return commensurate to the risk and sufficient to attract capital. These requirements must be tested against the record. They may not be brushed aside with a general finding of fair relationship. The Commission concedes that it did not equate jurisdictional costs to jurisdictional revenues. This is obvious because no determination was made of the jurisdictional revenues which the rates will produce." (App. A, pp. 412-13.)

The Court ordered that the Commission hold further hearings "to determine group revenues and group revenue requirements," and to make detailed findings to sustain the conclusion of fair relationship. (App. A, pp. 413, 431.)

The Court disapproved of the manner in which the Commission treated the problem of price deductions for poor quality gas. The Commission decided that the possibility of finding poor quality gas constituted a risk to the producers and that it should be included in the rate-of-return allowance. The Court rejected this position, and held that price deductions to reflect quality deviations are an item of cost and should be quantified and included "in the applicable base rates instead of hidden in a rate of return allowance."

(App. A, p. 423.) Only then, the Court held, could it review the adequacy of the rate-of-return allowance.

The Court found that the Commission's special relief provision was "insufficient and unsatisfactory." (App. A, p. 430.) This provision indicated that relief would be available for high cost producers who are unable to recover their costs under the applicable area rates. The Court agreed with the producers that this relief provision was "so vague and nebulous that neither they nor a Court can determine what relief is being granted." (App. A, p. 418.) It directed the Commission to establish relief provisions which "contain guidelines which if followed by an aggrieved producer will permit it to be heard promptly and to have a stay of the general rate order until its claim for exemption is decided. (App. A, p. 419.)

With regard to the quality standard for heating value, the Court did not understand why the Commission decided to have the downward adjustment begin at 1,000 Btu and the upward adjustment begin at 1,050 Btu. The Court directed that the Commission clarify its reasons for this 50 Btu gap between upward and downward adjustments in price. As for the other quality standards the Commission established, the Court did not expressly approve or disapprove them. However, it did refuse to resolve the producers' argument that the imposition of them violated procedural due process because of lack of notice, saying: "We are remanding the case and now everyone has notice." (App. A, p. 421.)

Certain respondents had filed petitions for rehearing before the Court of Appeals and on April 18, 1967, the lower Court issued a *per curiam* opinion and order on rehearing which is not as yet reported but is printed as Supplemental Appendix B submitted by the Petitioners People of the State of California and the California Public Utilities Commission.

ADDITIONAL STATEMENT OF THE CASE

The Court of Appeals' *per curiam* opinion and order on rehearing apparently remands the Federal Power Commission's (Commission) certificate order (J.A. 827d-838d) issued concurrently with Opinion No. 468. The concurrent certificate order concerned four separate applications under Section 7 of the Natural Gas Act for certificates of public convenience and necessity to sell gas produced in the area.[9] These applications were consolidated with the area rate proceeding and in the meantime temporary certificates were granted to all four applicants. By its concurrent certificate order the Commission granted permanent certificates to these applicants, but it conditioned them to an initial price no higher than the applicable area rates. Upon petition for rehearing by one of the applicants, Texaco Inc., in Docket No. C161-879, the Court of Appeals in its *per curiam* opinion has re-

[9]The four applications consolidated are: North Central Oil Corporation (Operator), *et al.*, Docket No. C160-435; Socony Mobil Oil Company, Inc., Docket No. C161-34; Robert T. Brown (Operator), *et al.*, Docket No. C161-733; Texaco Inc., Docket No. C161-879.

manded the concurrent certificate order in the Texaco Inc. matter, Docket No. C161-879. The Court probably intended its opinion and order to include remand of the Commission's entire certificate order. In any event, the lower Court expressly declined to either approve or disapprove the Commission's action to constitute the area rates determined under Sections 4 and 5 of the Act to be the initial price required by public convenience and necessity in certificate applications under Section 7. By its action the Court refused to approve the position adopted by the Commission.

Furthermore, the Court of Appeals' *per curiam* opinion and order reverses its original decision with regard to refunds of rates collected subject to refund under Section 4(e) of the Act. The Court below now adopts the position of the producers and holds that refunds on a rate schedule-by-rate schedule basis would be inconsistent with its conclusion that in an area rate proceeding group revenues must equal the group revenue requirement. Therefore, the Court prohibits any refunds when there is a group revenue deficiency. The Court directs that refunds may be ordered "on some equitable contract-by-contract basis" when group revenues exceed the group revenue requirements. In its change of position on this matter the Court withdraws its reliance upon *Federal Power Commission v. Tennessee Gas Transmission Company,* 371 U.S. 145 (1962), and relies upon *Second Phillips.*[10]

[10] *Wisconsin v. Federal Power Commission,* 373 U.S. 294 (1963).

REASONS FOR GRANTING THE WRIT

It should be pointed out that this first area rate proceeding has been a long one, over six years and still regulation of the industry has not been established. There is no reasonable price regulation. Potential refunds have accumulated over the years and price uncertainty remains. Consumers do not know if they are paying a fair and lawful price for the gas. Three other rate proceedings have been completed through the hearing stage and coupled with the Permain Basin case will affect regulation for about 70 percent of the interstate sale of natural gas. This Court must determine whether the Commission's decision is valid and lawful. If the decision of the lower Court remanding the Commission's decision is correct all these area rate proceedings must be reopened.

This petitioner feels the lower Court misinterpreted the *Hope* case as to the requirements for rate making and also suggestions as to area rate making in the *Second Phillips* case. In regard to the question of jurisdictional revenues balancing jurisdictional costs it seems to require disregard of the principles set out in *Federal Power Commission v. Sierra Pacific Power Company,* 350 U.S. 348 (1956).

The Court directed the Commission to clarify its reasons for the Btu gap but did not tell the Commission how to correct its decision as to the Btu gap.

A DECISION IS NECESSARY TO PROTECT THE CONSUMER

This petitioner intervened in the proceedings before the Commission because most of the gas produced in the Permian Basin is consumed in California. California has a growing demand for gas due to its explosive growth and uses approximately 11.1 percent of all the gas produced in the United States. Seventy-five percent of the gas needed in California is from out-of-state sources. Of this out-of-state supply 87 percent is obtained from El Paso Natural Gas Company and Transwestern Pipeline Company from sources in Texas, New Mexico, Oklahoma and Arizona. Thirteen percent of the out-of-state supply is imported from Canada.

The prime purpose of regulation of natural gas producers is to protect the consumer as set out in the Natural Gas Act. There are numerous decisions setting forth that the Act was framed to give consumers a "complete, permanent and effective bond of protection from excessive rates and charges," *Atlantic Refining Company v. Public Service Commission of the State of New York,* 360 U.S. 378 (1959).

There has been a wait of thirteen years for effective regulation and the lower Court's decision could cause further extensive delay to the consumers. The remand order of the lower Court is not clear and coupled with the risk of a second review proceeding could delay the result for years. Time is of the essence.

THE SUPREME COURT'S DECISIONS IN THE HOPE AND THE SIERRA PACIFIC CASES HAVE BEEN MISCONSTRUED

The lower Court concluded that the Commission failed to comply with the legal requirements for rate making under the Natural Gas Act and completely rejected the Commission's ruling that the end result test, set out in the *Hope* case, was satisfied by its finding that the rate order, when viewed in its entirety, established a fair relationship between the area rates prescribed by the Commission and the allowable cost of service for the area. The Commission's method involved consideration of composite cost data as necessary in rate making and other factors but did not find that group revenues would balance group costs. The lower Court concluded that the Commission must, under the end result test balance these costs and revenues.

The lower Court has misconstrued the *Hope* case which sets out that the Commission's order must be viewed in its entirety and there can be no strict formula and there must be flexibility and no single method must be followed by the Commission in considering the justness and reasonableness of rates.

Where a Commission cannot be restricted to a formula as set out by the *Hope* case the lower Court holds the opposite by stating that to justify the end result test that revenues must balance costs. Completely disregarded are other factors needed to be considered such as economic factors of the industry. It is felt the lower Court erred in limiting to an equation and rejecting the various economic factors considered by the Commission.

THE DECISION IS CONTRA TO THE SIERRA PACIFIC CASE

The Court of Appeals' decision is directly in conflict with this Court's decision in the case of *Federal Power Commission v. Sierra Pacific Power Company,* 350 U.S. 348 (1956) which held

> "In such circumstances the sole concern of the Commission would seem to be whether the (contract) rate is so low as to adversely affect the public interest."

The Court of Appeals implies that the Commission should raise low contract rates to the area rate in order to balance group revenues and group costs without showing that the contract rate is so low as to affect public interest.

The Court of Appeals holding such is a disregard of this Court's ruling and should not be allowed to stand.

THE COURT OF APPEALS ERRED IN TREATING THE METHOD TO PROVIDE FOR THE IMPACT OF THE QUALITY DEDUCTIONS.

Regulatory methods employed are immaterial so long as the end result was reasonable to the consumer and the investor. Such was the ruling in the *Hope* case. Here the Commission treated price deductions for deviations from pipeline quality gas as an item of risk. The Court has ordered the Commission to treat it as an item of cost which should be shown in the base rate. In deciding this item the Commission could determine that finding gas and a good quality of gas is a risk taken by a company. It is also incumbent on a company to bring gas up to a certain quality and the

cost of doing this is unknown during exploration. The Commission did find from the records substantial evidence that the quality impact would be in a certain range and held that the 12 percent rate of return was adequate and reasonable. The Court looked to the method employed and not to the end result as required by the *Hope* case.

THE REMAND ORDERED BY THE COURT BELOW AS TO SPECIAL RELIEF AND QUALITY PROVISIONS

The Commission held that there may be other circumstances where a producer as a matter of law or in the public interest would be entitled to some relief. Such clear situations governed by known or even unknown factors could cause such a change as to require special relief of some sort to the producer. The Court did not agree with the Commission but felt that the Commission referred only to confiscation and was therefore inadequate. However, the Court gave no advice as to what the Court should do upon remand.

THE COURT BELOW HAS REVERSED THE COMMISSION'S CONCURRENT CERTIFICATE ORDER WITHOUT GIVING ANY REASONS.

The Court of Appeals has remanded the Commission's concurrent certificate order on the ground that since this order establishes the area rate, which the Court has reversed and remanded, as the proper initial contract price to be permitted in the consolidated certificate proceedings, the certificate order also must be remanded.

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San Francisco submits that this action reverses the Commission's determination in Opinion No. 468 that the just and reasonable area rates would constitute the initial certificate price, less possible quality deductions, in subsequent Section 7 proceedings. After stating in the certificate order that the only issue involved is the level at which the initial price should be set, the Commission relies on its determination in Opinion No. 468 (J.A. 668d) to prescribe the area rates as the proper initial price in subsequent certificate proceedings. (J.A. 827d-828d.) Despite the Court's disclaimer that it has not spoken on the question whether the area rates may be constituted as initial certificate prices, the result of the Court's action is to reverse the Commission's determination on this question without giving any reasons. The Court has actually decided this question adversely to the Commission. San Francisco submits that the Court should have affirmed the Commission's determination even though the correct figure for the initial price would not be known due to the remand of its area rate determination.

The Court's action in reversing the Commission's determination on this issue without any discussion can only result in further delay in the development of area rate making. Such action is contrary to the primary purpose of the Act, which is to protect consumers. *Atlantic Refining Company, et al. v. Public Service Commission of New York,* 360 U.S. 378 (1959). If the position of the Court below prevails, its opinion on this issue would be required before further judicial review would be possible. San Francisco sub-

mits that this issue is properly before this Court in that the Commission expressed its view on it in Opinion No. 468 and in its concurrent certificate order. San Francisco urges that this Court review this issue and affirm the Commission's determination.

THE REVERSAL BY THE COURT BELOW OF ITS ORIGINAL POSITION ON THE REFUND QUESTION IS ERRONEOUS

The Court below has completely reversed itself on the question of the proper basis for refunds in an area rate proceeding. The Court originally said that it "saw no escape that refunds be on an individual company basis and on a schedule by schedule basis" and that if confiscation would result or the public interest would be harmed by any refund obligation the answer was an adequate special relief provision. (App. A to the Petition, pp. 426-27.) Now the Court says that refunds must be made on an industry area wide basis, thereby permitting refunds only if group area revenues exceed group area revenue requirements.

San Francisco submits that the lower Court's new position is unlawful. The Court's conclusion that *Federal Power Commission v. Tennessee Gas Transmission Company,* 371 U.S. 145 (1962), is no longer applicable because it dealt with zone rates is grossly inaccurate. That case announced fundamental and permanent principles regarding refunds under Section 4(e) of the Natural Gas Act, and it cannot be brushed aside on its facts. 371 U.S. 145, 152-3. The lower

Court would permit individual producers who have assumed the hazards involved in the Section 4 procedure to retain any illegal gain (i.e., that portion of rates which exceed the Commission's just and reasonable area rates and which were collected subject to refund) in the name of balancing group revenues with group revenue requirements. Such a result leaves producers in the best of all worlds—refund determinations made on a group basis and special relief determined on an individual basis. In addition, such a result is contrary to this Court's firm statement that regulation does not guarantee a profit. *Federal Power Commission v. Natural Gas Pipeline Company,* 315 U.S. 575, 590 (1942). It also violates this Court's decision in *Hope*[11] by permitting an end result totally unfair to consumers.

Likewise, the lower Court's reliance upon *Second Phillips* to justify its change of position is misplaced. The Commission decision in that case did not hold that increased rates collected subject to refund, which were higher than the subsequently determined just and reasonable rate, cannot be refunded because company overall costs exceed revenues for the test year. This Court expressly recognized in *Second Phillips* that the Commission had not made any determination of just and reasonable rates for the company because the Commission had found the individual company cost-of-service method was not adequate for producers. 373 U.S. 294, 306 n. 15. This Court approved

[11] *Federal Power Commission v. Hope Natural Gas Company,* 320 U.S. 591 (1944).

the Commission's termination of a limited number of consolidated rate increase proceedings for locked-in periods on the ground that it was not worth the time and cost to determine reasonable rates for certain past periods, and then determine the refunds required.

CONCLUSION

The City and County of San Francisco considers these questions of the greatest importance and the ultimate decision will have a great effect on all California consumers.

It is respectfully requested that this Petition be allowed to present these questions to the Court more completely.

Petitioner respectfully submits that this petition for a writ of certiorari to the United States Court of Appeals for the Tenth Circuit should be granted.

Dated, San Francisco, California,
June 14, 1967.

Respectfully submitted,

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ROBERT R. LAUGHEAD,
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Of Counsel.

PETITION FOR A WRIT OF CERTIORARI

JUN 19 1967
JOHN F. DAVIS, CLERK

In the Supreme Court of the United States

October Term, 1967

No. 262

THE CITY OF SAN DIEGO, a municipal corporation,

Petitioner,

vs.

SKELLY OIL COMPANY,
PHILLIPS PETROLEUM COMPANY,
WARREN PETROLEUM CORPORATION,
MOBIL OIL CORPORATION (formerly Socony Mobil Oil Company, Inc.),
PAN AMERICAN PETROLEUM CORPORATION,
NORTHERN NATURAL GAS PRODUCING COMPANY,

(Continued on Inside Cover)

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

EDWARD T. BUTLER
City Attorney

JOHN W. WITT
Chief Deputy City Attorney

Attorneys for The City of San Diego, a municipal corporation

(Continued from Cover)

STANDARD OIL COMPANY OF TEXAS, a Division of
Chevron Oil Company,
TEXACO INC.,
HUNT OIL COMPANY jointly with
H.L. Hunt,
Lamar Hunt,
N.B. Hunt,
W.H. Hunt,
Secure Trusts,
Caroline and Loyd B. Sands,
Caroline Hunt Trust Estate,
Lyda Hunt-Caroline Trusts,
Lyda Hunt-Bunker Trusts,
Lyda Hunt-Lamar Trusts,
Lyda Hunt-Herbert Trusts,
Lyda Hunt-Margaret Trusts
(formerly Estate of Lyda Bunker Hunt, Deceased),
Hunt Industries
(formerly Estate of Lyda Bunker Hunt, Deceased), and
Placid Oil Company,
HUMBLE OIL & REFINING COMPANY,
SHELL OIL COMPANY,
THE ATLANTIC RICHFIELD COMPANY (formerly
The Atlantic Refining Company) jointly with
Dorchester Gas Producing Company,
Southland Royalty Company, and
Westates Petroleum Company,
CONTINENTAL OIL COMPANY jointly with
Sunray DX Oil Company,
Sinclair Oil & Gas Company,
Cabot Corporation,
Sohio Petroleum Company,
Joseph E. Seagram & Sons, Inc.,
Joseph E. Seagram & Sons dba
Texas Pacific Oil Company,
Gulf Oil Corporation
Murphy Oil Corporation,
The Nueces Company
Samedan Oil Corporation,

(Continued from Inside Cover)

Cities Service Oil Company
(formerly Cities Service Petroleum Corporation),
Cities Service Production Company
(now merged with Cities Service Oil Company),
Columbian Fuel Corporation,
Amerada Petroleum Corporation,
Union Oil Company of California and as successor to
The Pure Oil Company,
Tidewater Oil Company,
Reef Corporation, and
William A. & Edward R. Hudson, Joint Operators,
MARATHON OIL COMPANY,
SUN OIL COMPANY,
INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA,
THE BRITISH-AMERICAN OIL PRODUCING COMPANY,
UNION TEXAS PETROLEUM, a Division of
Allied Chemical Corporation,
MIDHURST OIL CORPORATION,
THE SUPERIOR OIL COMPANY,
PERRY R. BASS jointly with
Panther City Investment Co.,
Bass Bros. Enterprise, Inc.,
Perry R. Bass, Incorporated, and
Richardson Oils, Inc.,
COLUMBIAN CARBON COMPANY jointly with
Coltexo Corporation,
THE STATE OF TEXAS,
BIG CHIEF DRILLING COMPANY jointly with
King-Stevenson Oil Co., Inc., and
Service Drilling Company
TEXAS INDEPENDENT PRODUCERS & ROYALTY OWNERS
ASSOCIATION jointly with
West Central Texas Oil and Gas Association
STATE OF NEW MEXICO,
GULF OIL CORPORATION, and
J.C. BARNES, et al., *Respondents.*

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In the Supreme Court of the United States

October Term, 1967

No. .....

THE CITY OF SAN DIEGO, a municipal corporation,

Petitioner,

vs.

SKELLY OIL COMPANY, et al.,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

Petitioner, The City of San Diego, respectfully prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Tenth Circuit entered on January 20, 1967.[1]

1. Petitioner was an intervenor in support of the Federal Power Commission, repondent in the court below. Respondents on this Petition for Writ of Certiorari were the petitioners in the court below.

OPINIONS BELOW

The opinion of the Court of Appeals (Cal. Pet. App. 382-431) and its opinion on rehearing (App. A, *infra*, pp. 1-3) are not yet reported.[2] The Federal Power Commission's Opinion Determining Just and Reasonable Rates for Natural Gas Producers in the Permian Basin, AR61-1, *et al.* (Opinion No. 468), and related orders, issued on August 5, 1965 (J.A. 516d-838d, 37s-40s, Cal. Pet. App. 1-346),[3] are reported at 34 FPC 159, 418, and 424 respectively; and its Opinion and Order Denying Applications for Rehearing of Opinion No. 468, AR61-1, *et al.* (Opinion No. 468-A), issued on October 4, 1965 (J.A. 1105d-1136d; Cal. Pet. App. 347-381), are reported at 34 FPC 1068. The opinion of the hearing examiner (J.A. 97d-364d) is reported at 34 FPC 306.

JURISDICTION

The judgments of the Court of Appeals were entered on January 20, 1967. They were modified by an order on rehearing entered on April 18, 1967 (App. A, *infra*, pp. 1-3). Petitioner did not petition for rehearing before the Court of Appeals.[4] On April 15, 1967, Mr. Justice White extended the

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2. "Cal. Pet. App." refers to the separate appendix filed in this Court by the State of California and the Public Utilities Commission of the State of California with their petition for certiorari (No. 1293).

3. The Joint Appendix contains thirteen volumes which are paginated as follows: Volumes I through V, which contain only testimony, are paginated 1 - 1908. Volumes VI through VIII, which contain exhibits presented during the hearings, are paginated 1e - 1146e. Volumes IX through XI, which contain pleadings, orders, and opinions, are paginated 1d - 1157d. There are also two small volumes - - a supplement numbered 1s - 40s, and a separate volume containing the table of contents for Volumes I through XI of the Joint Appendix.

4. Rule 26 of the United States Court of Appeals for the Tenth Circuit allows 20 days after judgment or decision to petition for rehearing.

time for filing a petition for a writ of certiorari on behalf of The City of San Diego to June 19, 1967. The jurisdiction of this Court is invoked under the provisions of 28 U.S.C., § 1254(1), and Section 19(b) of the Natural Gas Act (15 U.S.C., § 717r, para. (b)[5]).

QUESTIONS PRESENTED

1. Must the Federal Power Commission, in determining just and reasonable area rates under Sections 4 and 5 of the Natural Gas Act (15 U.S.C. §§ 717c, 717d), in order to satisfy the "end result" test of the *Hope Natural Gas* case,[6] determine (1) the allowable area cost of service for the gas produced in the area in question, including an allowance for exploration to meet future demand, (2) that the cost of service so determined constitutes the area revenue requirement, and (3) that the rates it establishes will recover the revenue required; or may it determine area rates which establish a fair relationship between the revenues derived from the rates prescribed and the allowable area cost of service?

2. In light of the *Sierra Pacific Power* case,[7] holding that rates voluntarily determined by contract, which are below those rates subsequently determined by the Federal Power Commission to be just and reasonable, are not required to be raised to the level of the just and reasonable rates unless the public interest so necessitates, must the Commission raise the low contract rates in order to insure that area revenues equal allowable area costs as determined by the Commission?

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5. Act of June 21, 1938, c. 556, § 19, 52 Stat. 831, as amended 15 U.S.C., § 717r, para. (b) (1958).

6. *Federal Power Commission* v. *Hope Natural Gas Co.* (1944) 320 U.S. 591.

7. *Federal Power Commission* v. *Sierra Pacific Power Co.* (1956) 350 U.S. 348.

3. In the fixing of group ceiling rates for pipeline-quality gas, is the 12 per cent rate of return allowed by the Commission adequate if it specifically recognized the fact that lower quality gas valued at a lower price might be found and where the Commission treated this possibility as an additional risk?

4. When the Federal Power Commission establishes just and reasonable area rates, and there is a possibility that some producers may require special relief from the rates so established did the Commission err by establishing a special provision announcing that producers requiring such relief may petition for it, but which does not specify detailed guidelines for the relief?

5. Is the Federal Power Commission's area rate decision so vague and unclear with regard to the establishment of the "Btu gap" in its Btu quality standard that clarification is required?[8]

6. When, under Sections 4 and 5 of the Natural Gas Act, the Federal Power Commission has established just and reasonable area rates, may the Commission also find that the area rates so determined constitute prospectively the initial price for certificating sales in the area under Section 7 of the Act (15 U.S.C. § 717f)?[9]

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8. If certiorari is granted, Petitioner also respectfully reserves the right to argue two additional questions:
   1. Whether the Commission gave adequate notice that it would prescribe quality standards in this proceeding.
   2. Whether the area rates fixed by the Commission are just and reasonable within the meaning of the Natural Gas Act. (This question covers the issues which the court below failed to reach due to its remand order. Petitioner will ask this Court to affirm the Commission's decision in all respects.)

9. The court below did not decide this question, instead remanding the case for further proceedings before the Commission as to the validity of the area rates. Petitioner believes the rates are valid and, therefore, urges this Court, if it similarly concludes they are valid, to decide this question at this time.

7. If the Federal Power Commission has established just and reasonable area rates, must area revenues exceed the allowable area cost of service before refunds of contract rates may be ordered by the Commission, when the contract rates were collected subject to refund under Section 4 of the Act?

STATUTE INVOLVED

The relevant provisions of the Natural Gas Act, 52 Stat. 821, as amended 15 U.S.C., §§ 717-717w, are set forth in Cal. Pet. App. Appendix B. They are Sections 4, 5, 16, and 19 of the Natural Gas Act (15 U.S.C. §§ 717c, 717d, 717o, and 717r). In addition, Section 7 of the Act (15 U.S.C. § 717f) is set forth in Appendix B to this Petition.

STATEMENT OF THE CASE

The background of the controversy which is reflected in this case begins with *Phillips Petroleum Company* v. *Wisconsin* (1954) 347 U.S. 672, a case now generally called "*First Phillips*." The events and decisions which occurred over the next nine years are ably set out in Mr. Justice Harlan's majority opinion in "*Second Phillips*," *Wisconsin* v. *Federal Power Commission* (1963) 373 U.S. 294, reh. den. (1963) 375 U.S. 870. The difficulty has been in finding a regulatory method fair to all parties in the complex natural gas industry. As this Court noted in *Second Phillips:*

> . . . (T)o declare that a particular method of rate regulation is so sanctified as to make it highly unlikely that any other method could be sustained would be wholly out of keeping with this Court's consistent and clearly articulated approach to the question of the Commission's power to regulate rates. It has repeatedly been stated that no single method need be followed by the Commission in considering the justness and reasonableness of rates, ... We recognize the unusual

> difficulties inherent in regulating the price of a commodity such as natural gas. We respect the Commission's considered judgment, backed by sound and persuasive reasoning, that the individual company cost-of-service method is not a feasible or suitable one for regulating the rates of independent producers. We share the Commission's hopes that the area approach may prove to be the ultimate solution.[10]

Following the decision in *Second Phillips, supra,* the Federal Power Commission on December 23, 1960, set down its first case using the area rate method. The area chosen was the Permian Basin which is located in southeastern New Mexico and western Texas. Its most important natural gas distribution area is Southern California.

San Diego, with a population of 687,200, is the sixteenth largest city in the United States. It has a metropolitan area with a population slightly in excess of 1,000,000. Natural gas is depended upon as the major source of energy for residential and industrial use. The supply of natural gas at just and reasonable prices is of vital importance to the petitioner and its residents.

Hearings in the Permian Basin case began before the FPC on October 11, 1961. The proceeding involved 251 days of hearings, a transcript containing 30,369 pages and some 337 exhibits. Hearings concluded on September 12, 1963.

Following the filing of briefs by the parties, the matter was submitted to the hearing examiner for his initial decision. That decision was rendered on September 17, 1964. Oral argument which followed briefs on separations was heard by the full Commission commencing February 8, 1965. Its decision, No. 468, was issued on August 5, 1965.[11]

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10. 373 U.S. at pp. 309-310.

11. Opinion No. 468 is found in Cal. Pet. App., p. 1-346.

After petitions for rehearing were filed, the Commission issued Opinion No. 468-A on October 4, 1965. Opinion No. 468-A denied the applications for rehearing, but modified the initial opinion where the Commission deemed appropriate.[12]

The first of the producers to file a petition for review by the Court of Appeals for the Tenth Circuit was Skelly Oil Company which did so on September 13, 1965. Its fellow producers, respondents herein, followed Skelly's lead. The opinion of the Court of Appeals was issued on January 20, 1967. The Court remanded the proceedings to the Commission for further hearings.[13]

On April 18, 1967, the Court of Appeals issued a *per curiam* opinion and order on rehearing which is not as yet reported. This *per curiam* opinion and order on rehearing was printed as Appendix B to this Petition.

REASONS FOR GRANTING THE WRIT

1. A decision by This Court on the Validity of Area Rate Making is Needed Due to the National Importance to Consumers of Effective Natural Gas Producer Regulation.

The historical background of this case paints a picture of lengthy development of the area rate making method. It has been thirteen years since this Court in *First Phillips* decided that independent producers are natural gas companies within the meaning of the Natural Gas Act and that their sales for resale in interstate commerce are therefore subject to regulation by the FPC. Since then the natural gas consumer has been waiting for effective regulation. Meanwhile, rate increases have been added, all without any final determination of just and reasonable rates.

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12. Opinion No. 468-A is found in Cal. Pet. App., pp. 347-381.

13. Opinion of the U.S. Court of Appeals for the Tenth Circuit is found in Cal. Pet. App., pp. 382-431.

Ultimately, we believe San Diego residents will pay the rates determined by the Commission in the orders reviewed by the Court below. The result will be rate reductions and substantial refunds to the benefit of ultimate consumers in San Diego and elsewhere. This Court in *Federal Power Commission* v. *Tennessee Gas Transmission Co.* (1962) 371 U.S. 145, 154-155, stated:

> True, the exaction would have been subject to refund, but experience has shown this to be somewhat illusory in view of the trickling down process necessary to be followed, the incidental cost of which is often borne by the consumer, and in view of the transient nature of our society which often prevents refunds from reaching those to whom they are due.

In other words, this Court has already observed that the possibility of refunds is a questionable protection to consumers that have been required to pay excessive prices.

The large total amount of refunds already due consumers, estimated to be nearly $40,000,000, presents the possibility that realization of these refunds by the consumers will be virtually impossible because of the irreparable damage it would cause the entire producing industry. Therefore, time is of the essence. The questions now in the appellate process petitioner submits will ultimately be decided by this Court. It is important that they be so decided as soon as possible.

2. This Court's Decisions Relative to Rate Making Under the Natural Gas Act Have Been Misconstrued by the Court Below.

The Court below concluded that the controlling standard for area rate making is the end result test of the *Hope* case.[14]

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14. *Federal Power Commission* v. *Hope Natural Gas Co.* (1944) 320 U.S. 591.

The Court rejected the Commission's determination that the end result test was satisfied by a finding that the rate order, when viewed in its entirety, established a fair relationship between the area rates prescribed by the Commission and the allowable cost of service for the area. In other words, the Court below seems to have read the *Hope* case to require the Commission to find the cost of gas sold by producers as a group and provide rates to cover those costs. The method used by the Commission involved a consideration of composite cost data as a basic ingredient in area rate making, as well as other economic and policy factors, but it did not involve a specific finding that group revenues would balance group costs. The conclusion of the Court below ruled that The Commission must under the *Hope* end result test balance these costs and revenues.

The Court below has adopted the contention of the producers that once composite cost-of-service data are utilized in area rate making, the Commission must proceed as it would in an individual utility company cost-of-service proceeding. To take this position one must interpret the *Hope* end result test to be extremely rigid and narrow, as if it were no different from individual company cost-of-service rate making. The end result test, however, gives the Commission much greater flexibility. In fact, this Court ruled in *Hope* that the end result test really asks the question, when the Commission's order is challenged in the courts, whether that order "viewed in its entirety" meets the requirements of the Natural Gas Act.[15] This was recognized in *Second Phillips* when this Court observed, ". . . the Court has never held that the individual company cost-of-service method is a *sine qua non* of natural gas rate regulation." The Court

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15. 320 U.S. at p. 602.

below furthermore overlooked some other very important words from the *Hope* case:

> . . . The Commission's order does not become suspect by reason of the fact that it is challenged. It is the product of expert judgment which carries a presumption of validity. And he who would upset the rate order under the Act carries the heavy burden of making a convincing showing that it is invalid because it is unjust and unreasonable in its consequences.[16]

There has been no showing that the rate order in the case at bar was unjust and unreasonable in its consequences. Furthermore, the Court below has overlooked an important rule of this Court of some thirty-five years standing: "A rate order cannot be upset on judicial review unless confiscation is clearly shown."[17] This Court in *Federal Power Commission* v. *Sierra Pacific Power Company* (1956) 350 U.S. 348, held that voluntarily made rates which are below the just and reasonable rate determined by the Commission cannot be raised merely because they are unprofitable. In requiring that group revenues balance group costs, the Court below appears to state that where a natural gas company contracts to sell at a rate resulting in less than a fair return, the Commission must raise that rate in order to make group revenues equate to group costs in an area rate proceeding. This appears directly contrary to the *Sierra Pacific* decision. If the correct view is that area rate making is only another instance of individual company cost-of-service rate making, then, under the *Sierra Pacific* case, producers may not be relieved from their voluntarily made low contract rates. Yet this appears to be precisely the position of the Court below.

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16. 320 U.S. at p. 602.

17. *Los Angeles Gas & Electric Co.* v. *Railroad Commission* (1933) 289 U.S. 287; *Lindheimer* v. *Illinois Bell Tel. Co.* (1934) 292 U.S. 151.

3. In Regard to the Special Relief and Quality Provisions the Remand Order of the Court Below is Vague.

The decision of the Court below takes a particularly curious turn when it comes to the subject of the Commission's special relief provisions and its quality standards. As to the clause by which the Commission sought to allow special relief when the public interest or constitutional considerations required it, the Court below found the provision to be "vague and nebulous." It said:

> The producers are right in saying that the Commission's exemption provisions are so vague and nebulous that neither they nor a court can determine what relief is being granted. . . An adequate savings clause should contain guidelines which if followed by an aggrieved producer will permit it to be heard promptly and to have a stay of the general rate order until its claim for exemption is decided.[18]

The Court below apparently read the Commission's decision as to this matter to be intended to grant relief only from confiscation. But the Commission specifically stated that "there may be other circumstances where a producer as a matter of law or in the public interest would be entitled to some relief" (J.A. 658d). This provision, therefore, was designed to provide notice that relief would be available. The Commission made no attempt to foresee all the situations which might justify such special relief nor what the relief in those situations might be. Specifics were left for the time when the need for such relief might arise.

To require the Commission to specify every conceivable factual situation which might cause an appropriate claim for special relief, and to decide what that relief might be, is asking the Commission to foresee all the eventualities which

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18. Cal. Pet. App. pp. 418-419.

might arise in a brand new system of rate making. It is submitted that such a task is virtually impossible.

Furthermore, the lower Court's blanket mandatory "stay of the general order" is judicially unique. The general rule is that stays will be granted only upon a showing of irreparable injury to the producer concerned. The mere possibility that a producer is entitled to special relief from area rates does not justify the continuance of collecting rates which have been held to be too high. *Federal Power Commission* v. *Tennessee Gas Transmission Company* (1962) 371 U.S. 145, 151-152, 154; *United Gas Improvement Co.* v. *Callery Properties, Inc.* (1965) 382 U.S. 223.

With regard to quality standards, the lower Court specifically required explanation why the Commission provided the "Btu gap" in its quality standard for Btu content (Cal. Pet. App. p. 421). At the same time the Court failed to approve or disapprove the other quality standards, commenting that it would not resolve at the time the producers' contention that procedural due process was violated because of lack of notice on the matter of quality standards. The effect of the lower Court's decision is to reverse the Commission on all its quality standards without giving any reasons.

4. The Court Below Has Given No Reasons for Reversing the Commission's Concurrent Certificate Order.

On rehearing, the lower Court's per curiam opinion (Appendix A to this Petition) held that the Commission's concurrent certificate order establishes the area rate as the proper initial contract price to be permitted in the consolidated certificate proceedings and, since this area rate has been reversed and remanded, the certificate order also must be remanded. The effect of this holding is to reverse the Commission's determination on the question of whether the area rates may be constituted as initial certificate prices

without giving any reasons. If the position of the Court below prevails, its opinion on this issue would be required before further judicial review would be possible, all to the further delay of this case, which already has become extremely protracted. Petitioner submits that this issue is properly before this Court in that the Commission expressed its views on it in Opinion No. 468 and in its concurrent certificate order. Petitioner urges that this Court review this issue and affirm the Commission's determination.

5. It is Erroneous for the Court Below to Reverse its Original Position on the Refund Question.

In its opinion on rehearing the Court of Appeals completely reversed itself on the question of the proper basis for refunds in an area rate proceeding. Originally it had said that it "saw no escape from the requirement that refunds be on an individual company basis and on a schedule by schedule basis," that if confiscation would result the public interest would be harmed by any refund obligation. The answer was an adequate special relief provision (Cal. Pet. App. pp. 426-427).

On rehearing, the Court's position is that refunds must be made on an industry area-wide basis thereby permitting refunds only as group area revenues exceed group area requirements. In coming to this conclusion, the Court indicates that its reliance on *Federal Power Commission* v. *Tennessee Gas Transmission Co., supra,* was misplaced on the ground that the *Tennessee Gas Transmission Co.* case dealt with zone rights. But that case announced fundamental rules regarding refunds under Section 4(e) of the Natural Gas Act. The lower Court's holding would permit individual producers involved in a Section 4 procedure to retain any illegal gain representing the portion of rates which exceeds the Commission's just and reasonable area rates, and which were

collected subject to refund, in order to balance group revenues with group revenue requirements. Producers would then be in a position where refund determinations would be made on a group basis and special relief on an individual basis. Such a result is contrary to this Court's firm statement that regulation does not guarantee a profit. *Federal Power Commission* v. *Natural Gas Pipeline Co.* (1942) 315 U.S. 575,590. It also violates this Court's decision in *Hope, supra,* by permitting an end result totally unfair to consumers.

CONCLUSION

Petitioner respectfully submits that the opinions and orders of the Court of Appeals for the Tenth Circuit in this case are erroneous and petitioner respectfully prays that a Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit should issue.

Respectfully submitted,

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Dated: June 14, 1967

APPENDIX A

UNITED STATES COURT OF APPEALS
TENTH CIRCUIT

Nos. 8385 etc., March Term, 1967

Filed–United States Court of Appeals Tenth Circuit
Apr 18 1967
William L. Whittaker, Clerk

SKELLY OIL COMPANY, et al.,
Petitioners,

v.

FEDERAL POWER COMMISSION,
Respondent.

ON REHEARING.

PER CURIAM.

Texaco Inc. asserts that the opinion is not clear as to the disposition of its Docket No. C161-879 *(sic)* in which, by an order separate and apart from Opinions Nos. 468 and 468-A and their accompanying orders, a § 7 certificate was issued at a rate of 14.5 cents less quality deductions. This separate order shows that the Commission treated the area rate as the in-line rate for § 7 certificates.

The order on this docket was lost in the mass of material presented to us. No party made a point of it. We have reconsidered the Texaco petition for review and have concluded that it is sufficiently broad to cover such order. It should receive the same treatment as the § 4 and § 5 proceedings. Accordingly, the remand includes the separate order entered in Docket No. C161-879 *(sic)*.

We note that in its disposition of this particular docket the Commission took the position that an established area rate automatically becomes the in-line rate for a § 7 proceeding. The same position was taken by the Commission in its Opinion No. 484 which we are today reversing by our decision in Nos. 8723 etc.—Phillips Petroleum Company, et al., v. Federal Power Commission,....F.2d.... We there hold that in a § 7 application heard by the Commission after its Permian decision the adoption of the area rate as an in-line rate must fall because we have rejected the area rate. We do not there, and we do not here, express either approval or disapproval of the principle that an area rate established in a § 5 proceeding automatically becomes an in-line rate for a § 7 proceeding. The validity of such a principle may be affected by the final determination of the validity of the Permian Basin area rate.

Various producers insist that we erred in our treatment of refunds. We held that refunds must be on a company-by-company and schedule-by-schedule basis. We are now convinced that such holding was wrong and is inconsistent with our conclusion that satisfaction of the end result test requires rates which will equate group revenues with group revenue requirements.

The refunds in question relate to collections made during the so-called "locked-in" periods, i.e., the periods during which an increased rate, later superseded by a further increase, is effective. See Second Phillips, 373 U.S. 294, 298, fn. 5. In that case the Court said that on the locked-in rate issue "the sole question was whether all or any part of the increases had to be refunded by Phillips." The Court pointed out that the Commission decided that the increases did not bring revenues up to cost of service, and held that the Commission "properly concluded" that "no refund obligations could be imposed." Id. at 306.

We are now convinced that this treatment of refund obligations for locked-in rates in the case of an individual company in Second Phillips must be applied on a group basis when an area rate is fixed and tested by the end result. We are also convinced that our reliance on Federal Power Commission v. Tennessee Gas Transmission Co., 371 U.S. 145, was misplaced. That case dealt with zone rates. The Second Phillips decision on locked-in rates came later.

This modification of the opinion means that no refund obligation may be imposed for a period in which there is a group revenue deficiency. When group revenues exceed group revenue requirements, refunds may be ordered on some equitable contract-by-contract basis. In fixing an area rate, the Commission must consider the effect which past and potential refunds have on the balancing of group revenues with group revenue requirements.

In all respects, except those specifically noted herein, the petitions for rehearing are severally denied.

APPENDIX B

Section 7 of the Natural Gas Act

Construction, extension, or abandonment of facilities; certificate of convenience and necessity; condemnation proceedings

Sec. 7. (a) Whenever the Commission, after notice and opportunity for hearing, finds such action necessary or desirable in the public interest, it may by order direct a natural-gas company to extend or improve its transportation facilities, to establish physical connection of its transportation facilities with the facilities of, and sell natural gas to, any person or municipality engaged or legally authorized to engage in the local distribution of natural or artificial gas to the public, and for such purpose to extend

its transportation facilities to communities immediately adjacent to such facilities or to territory served by such natural-gas company, if the Commission finds that no undue burden will be placed upon such natural-gas company thereby: *Provided*, That the Commission shall have no authority to compel the enlargement of transportation facilities for such purposes, or to compel such natural-gas company to establish physical connection or sell natural gas when to do so would impair its ability to render adequate service to its customers.

(b) No natural-gas company shall abandon all or any portion of its facilities subject to the jurisdiction of the Commission, or any service rendered by means of such facilities, without the permission and approval of the Commission first had and obtained, after due hearing, and a finding by the Commission that the available supply of natural gas is depleted to the extent that the continuance of service is unwarranted, or that the present or future public convenience or necessity permit such abandonment.

(c) No natural-gas company or person which will be a natural-gas company upon completion of any proposed construction or extension shall engage in the transportation or sale of natural gas, subject to the jurisdiction of the Commission, or undertake the construction or extension of any facilities therefor, or acquire or operate any such facilities or extensions thereof, unless there is in force with respect to such natural-gas company a certificate of public convenience and necessity issued by the Commission authorizing such acts or operations: *Provided, however,* That if any such natural-gas company or predecessor in interest was bona fide engaged in transportation or sale of natural gas, subject to the jurisdiction of the Commission, on February 7, 1942, over the route or routes or within the area for which application is made and has so operated since that time, the Commission shall issue such certificate without requiring

further proof that public convenience and necessity will be served by such operation, and without further proceedings, if application for such certificate is made to the Commission within ninety days after February 7, 1942. Pending the determination of any such application, the continuance of such operation shall be lawful.

In all other cases the Commission shall set the matter for hearing and shall give such reasonable notice of the hearing thereon to all interested persons as in its judgment may be necessary under rules and regulations to be prescribed by the Commission; and the application shall be decided in accordance with the procedure provided in subsection (e) of this section and such certificate shall be issued or denied accordingly: *Provided, however,* That the Commission may issue a temporary certificate in cases of emergency, to assure maintenance of adequate service or to serve particular customers, without notice or hearing, pending the determination of an application for a certificate, and may by regulation exempt from the requirements of this section temporary acts or operations for which the issuance of a certificate will not be required in the public interest.

(d) Application for certificates shall be made in writing to the Commission, be verified under oath, and shall be in such form, contain such information, and notice thereof shall be served upon such interested parties and in such manner as the Commission shall, by regulation, require.

(e) Except in the cases governed by the provisos contained in subsection (c) of this section, a certificate shall be issued to any qualified applicant therefor, authorizing the whole or any part of the operation, sale, service, construction, extension, or acquisition covered by the application, if it is found that the applicant is able and willing properly to do the acts and to perform the service proposed and to conform to the provisions of this chapter and the

requirements, rules, and regulations of the Commission thereunder, and that the proposed service, sale, operation, construction, extension, or acquisition, to the extent authorized by the certificate, is or will be required by the present or future public convenience and necessity; otherwise such application shall be denied. The Commission shall have the power to attach to the issuance of the certificate and to the exercise of the rights granted thereunder such reasonable terms and conditions as the public convenience and necessity may require.

(f) The Commission, after a hearing had upon its own motion or upon application, may determine the service area to which each authorization under this section is to be limited. Within such service area as determined by the Commission a natural-gas company may enlarge or extend its facilities for the purpose of supplying increased market demands in such service area without further authorization.

(g) Nothing contained in this section shall be construed as a limitation upon the power of the Commission to grant certificates of public convenience and necessity for service of an area already being served by another natural-gas company.

(h) When any holder of a certificate of public convenience and necessity cannot acquire by contract, or is unable to agree with the owner of property to the compensation to be paid for, the necessary right-of-way to construct, operate and maintain a pipe line or pipe lines for the transportation of natural gas, and the necessary land or other property, in addition to right-of-way, for the location of compressor stations, pressure apparatus, or other stations or equipment necessary to the proper operation of such pipe line or pipe lines, it may acquire the same by the exercise of the right of eminent domain in the district court of the United States for the district in which such property may

be located, or in the State courts. The practice and procedure in any action or proceeding for that purpose in the district court of the United States shall conform as nearly as may be with the practice and procedure in similar action or proceeding in the courts of the State where the property is situated: *Provided,* That the United States district courts shall only have jurisdiction of cases when the amount claimed by the owner of the property to be condemned exceeds $3,000. (52 Stat. 824 (1938); 15 U.S.C. § 717f, as amended.)

PETITION FOR A WRIT OF CERTIORARI

FILED
JUN 19 1967
JOHN F. DAVIS, CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1967

No. 266

(Permian Basin Area Rate Cases)

STANDARD OIL COMPANY OF TEXAS, A DIVISION OF CHEVRON OIL COMPANY, *Petitioner*,

v.

FEDERAL POWER COMMISSION, *Respondent*.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

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June 19, 1967

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1967

No.

(Permian Basin Area Rate Cases)

STANDARD OIL COMPANY OF TEXAS, A DIVISION OF CHEVRON OIL COMPANY, *Petitioner*,

v.

FEDERAL POWER COMMISSION, *Respondent*.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

Standard Oil Company of Texas, a Division of Chevron Oil Company, petitioner, prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Tenth Circuit, entered in this case on January 20, 1967. The Court's Order on Rehearing was entered on April 18, 1967

QUESTIONS PRESENTED

In addition to questions raised in the petitions for writs of certiorari filed by other producers, petitioner presents the following question:

Whether the Commission erred in adopting a rate base determined by averaging the value of depleting properties over an assumed 20-year life.

STATEMENT

The Commission prescribed rates for new gas-well gas based upon a cost calculation which includes an allowance for operating cost, exploration cost, annual depletion and return on net investment. Net investment was calculated at approximately 50 percent of the actual gross investment. The Commission reasoned that since the rate base was composed of depleting properties (a 1-year holding period and a 20-year life was assumed) net investment should be fixed at 50 percent of the gross initial investment. The Court of Appeals affirmed the Commission on this point without discussion.

REASONS FOR GRANTING THE WRIT

1. This case is a companion case to Nos. 1274, 1287, 1291, 1292, 1293, 1294, 1295, 1302, 1342 and 1412, October Term 1966 (the Permian Basin Area Rate Cases). This petition is filed to protect petitioner's right to present to this Court the question above stated, in addition to the questions raised in the petitions of the other producers. The petition herein should be granted for the same reasons that the petitions in the other companion cases have been granted.

2. The establishment of a rate on the arbitrary assumption that 50 percent of the gross investment is the

value of the property devoted to the public service during each year of the life of a depleting property is clearly erroneous, is confiscatory and is in conflict with the earlier decision of the Respondent Commission in *South Carolina Generating Co.* (1956) 16 F.P.C. 52, 57, 59. Petitioner knows of no regulatory precedent or judicial sanction for requiring petitioner to operate at less than a reasonable rate of return for a ten-year period in anticipation that in a subsequent ten-year period it may collect excess rates and thereby be made whole. "Present confiscation is not atoned for by merely holding out the hope of a better life to come." (*West Ohio Gas Co.* v. *Public Utilities Comm. of Ohio* (1935) 294 U.S. 79, 83). It is an established principle of this Court that property cannot be taken for public use without the assurance of a reasonable rate of return on the value of the property at the time it is being used for the public (*West* v. *C. & P. Tel. Co.* (1935) 295 U.S. 662).

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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June 19, 1967

PETITION FOR A WRIT OF CERTIORARI

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No. 388

IN THE

Supreme Court of the United States

OCTOBER TERM, 1967

(Permian Basin Area Rate Cases)

MOBIL OIL CORPORATION AND NORTHERN NATURAL GAS PRODUCING COMPANY, *Petitioners,*

v.

FEDERAL POWER COMMISSION

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

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July 17, 1967

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1967

No.

(Permian Basin Area Rate Cases)

MOBIL OIL CORPORATION AND NORTHERN NATURAL GAS PRODUCING COMPANY, *Petitioners,*

v.

FEDERAL POWER COMMISSION

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

Mobil Oil Corporation and Northern Natural Gas Producing Company, petitioners, pray that a Writ of Certiorari issue to review the judgments of the United States Court of Appeals for the Tenth Circuit in this case entered on January 20, 1967. That Court's order on rehearing was entered on April 18, 1967.[1]

---

[1] This case is one of the Permian Basin Area Rate Cases in which this Court granted all then pending petitions on June 12, 1967 in Nos. 90, *et al.*, Oct. Term, 1967 (Nos. 1274, *et al.*, Oct. Term, 1966).

OPINIONS BELOW

Opinions of the Federal Power Commission, reported at 34 F.P.C. 159 and 34 F.P.C. 1068, are reproduced in the Joint Appendix filed in Nos. 90, *et al.* (J.A. X-516d-XI-826d, J.A. XI-1105d). The opinions of the Court of Appeals, reproduced in Appendices to petitions in Nos. 90, *et al.*, are reported at 375 F. 2d 6.

JURISDICTION

The judgments of the Court of Appeals for the Tenth Circuit were entered on January 20, 1967. Petitioners filed a timely petition for rehearing. The Court's order on rehearing, modifying its opinion in part, was entered on April 18, 1967. Jurisdiction of this Court is invoked under Section 19(b) of the Natural Gas Act, 15 U.S.C. § 717r(b), and 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether the Federal Power Commission may lawfully impose a system of rates based on classifying natural gas as "new" or "old" according to the date of execution of gas sales contracts, and impose lower rates for sales of "old" gas under the contracts executed prior to the selected cut-off date?

2. Whether, in proceedings under Sections 4 and 5 of the Natural Gas Act, the Federal Power Commission may impose a "moratorium" prohibiting the future filing of contractually-authorized rate increases and barring hearings to determine "reasonableness" of such increased rates under Section 4 of the Act?

3. When the Federal Power Commission has issued certificates authorizing sales of natural gas under contracts considered by the Commission in its certificate proceedings, and deliveries have commenced under

such certificates and contracts, may the Commission subsequently, without hearing or findings upon "justness and reasonableness" of prices to be charged, invalidate and proscribe future price adjustment clauses in these same contracts?

4. Whether in compiling composites of group costs used to determine producers' "revenue requirements" and to prescribe area rates under Sections 4 and 5 of the Natural Gas Act, the Federal Power Commission may exclude from such composites the costs incurred by the producing industry in gathering and processing natural gas for sales to pipeline purchasers?

STATUTES INVOLVED

Statutory provisions involved are Sections 4 and 5(a) of the Natural Gas Act, 15 U.S.C. §§ 717c and 717d(a), reproduced in appendices to petitions in Nos. 90, *et al.*

STATEMENT

Statements in the petitions filed in Nos. 90, *et al.*, fully set forth the history of this case before the Federal Power Commission and the Court of Appeals. On the questions here presented, the Commission's opinions and orders (1) impose a "dual price" system of "area rates" under which gas sold under contracts executed on or after January 1, 1961 is eligible for a "new gas" price, but a considerably lower "old gas" price is imposed upon gas sold under contracts executed prior to that date;[2] (2) impose a "moratorium" upon future

[2] *E.g.*, under the Commission system, natural gas classified as "new" "gas-well gas" of "pipeline quality" produced in the Texas fields here involved may be sold at a rate of 16.5 cents per Mcf, while "old" gas of the same quality produced in the same fields may be sold at a rate of only 14.5 cents.

filings under Section 4 of the Act to obtain authorized rate increases, the "moratorium" here imposed being from September 1, 1965 to January 1, 1968; (3) prohibit future filings pursuant to flexible pricing clauses in existing sales contracts, even though certificates authorizing sales in accordance with these contracts had previously been issued by the Commission under Section 7; and (4) are predicated upon "area" and average costs of producers compiled on a group basis without including in such costs the substantial expenses incurred by producers in gathering and processing natural gas prior to delivery to pipeline purchasers.

Petitioners unsuccessfully sought rehearing before the Commission on these issues and thereafter sought reversal of the Commission in the Court of Appeals. However, the Court of Appeals' opinions of January 20, 1967 and April 18, 1967, sustain the Commission's decisions on these issues and thus are adverse to Petitioners.[8]

REASONS FOR GRANTING THE WRIT

By orders entered June 12, 1967, this Court has undertaken review of the opinions and judgments of the court below in the Permian Basin Area Rate Cases. Questions presented in the petitions in Nos. 90, *et al.*, indicate that such review will extend comprehensively to a broad spectrum of issues passed upon by the court below. These Petitioners, therefore, seek to be heard

[8] On certain other issues raised by Petitioners, the Court of Appeals reversed the Commission, and these Petitioners thus are now respondents in Nos. 100, 102, 117, 181, 261, and 262, Oct. Term 1967.

on the questions decided adversely to them below, particularly as to questions upon which Petitioners' arguments may differ from presentations by petitioners in Nos. 90, *et al.* Since the Court has so undertaken comprehensive review, these Petitioners should be heard upon these questions for reasons already fully set forth in the petitions in Nos. 90, *et al.*

On June 12, 1967, this Court also entered an order providing for a briefing schedule applicable to the group of related cases then here and to any petitions in the Permian Basin Area Rate Cases subsequently granted. The schedule requires filing of briefs on August 25, 1967 by parties supporting the Commission's order, and the filing of briefs on October 9, 1967 by parties opposing the Commission's order. These Petitioners are already proceeding under that schedule and will file appropriate briefs on October 9, 1967. Granting of this petition thus will not interfere with the schedule established in Nos. 90, *et al.* Therefore, in the light of the position of the Federal Power Commission of acquiesence in the granting of all petitions seeking review of the judgments below in these cases as set forth in its "Motion To Expedite Proceedings" filed in No. 1342 on May 1, 1967, and of this Court's orders of June 12, 1967 in Nos. 90, *et al.*, this petition should be granted.

CONCLUSION

The petition for a writ of certiorari should be granted, and this case should be consolidated with Nos. 90, *et al.*, subject to the Court's order of June 12, 1967 as to filing of briefs and allotment of time for oral argument.

Respectfully submitted,

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July 17, 1967

APPENDIX

APPENDIX

APPENDIX A

UNITED STATES COURT OF APPEALS FOR
THE TENTH CIRCUIT

Thirteenth Day, January Term, Friday, January 20th, 1967

* * * * * * * * * * *

Before HONORABLE DAVID T. LEWIS, HONORABLE JEAN S. BREITENSTEIN AND HONORABLE DELMAS C. HILL, Circuit Judges

8455

MOBIL OIL CORPORATION (FORMERLY SOCONY MOBIL OIL COMPANY, INC.), *Petitioner*

v.

FEDERAL POWER COMMISSION, *Respondent*

On Petition to Review an Order of the Federal Power Commission

This cause came on to be heard on petition to review an order of the Federal Power Commission and motion to adduce additional evidence and was argued by counsel.

On consideration whereof, it is ordered by this court that the motion to adduce additional evidence is hereby denied. The petition to review is granted and the case is remanded to the Commission for further proceedings consistent with the opinion of the court.

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8460

NORTHERN NATURAL GAS PRODUCING COMPANY, *Petitioner*

v.

FEDERAL POWER COMMISSION, *Respondent*

On Petition to Review an Order of the Federal Power Commission

This cause came on to be heard on petition to review an order of the Federal Power Commission and motion to adduce additional evidence and was argued by counsel.

On consideration whereof, it is ordered by this court that the motion to adduce additional evidence is hereby denied. The petition to review is granted and the case is remanded to the Commission for further proceedings consistent with the opinion of the court.

The Court's order on rehearing is reproduced in Supplement Appendix B to the Motion for Leave to Supplement the Petition in the companion case No. 100, Oct. Term 1967 (No. 1293, Oct. Term, 1966).

BRIEF

SUPREME COURT, U. S.
FILED
AUG 24 1967
JOHN F. DAVIS, CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1967

No. 90 et al

PERMIAN BASIN AREA RATE CASES

On Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit.

BRIEF FOR THE CITY OF LOS ANGELES.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1967

No. .....

PERMIAN BASIN AREA RATE CASES

On Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit.

BRIEF FOR THE CITY OF LOS ANGELES.

Opinions Below.

The opinion of the Court of Appeals and its opinion on rehearing are reported at 375 F. 2d 6. The opinions and orders of the Federal Power Commission (J.A. 516d-826d, 827d-838d, 37s, 1105d-1132d, and 1133d-1136d;[1] Cal.Pet.App. 1-381) are reported at 34 F.P.C. 159, 418, 424, 1068, and 1082. The opinion of the hearing examiner (J.A. 97d-364d) is reported at 34 F.P.C. 306.

[1]The Joint Appendix in the court of appeals consists of thirteen volumes paginated as follows: Volumes I-V, which contain only testimony, are paginated 1-1908. Volumes VI-VIII, which contain exhibits presented during the hearings, are paginated 1e-1146e. Volumes IX-XI, which contain pleadings, orders, and opinions, are paginated 1d-1157d. There are also two small volumes—a supplement paginated 1s-40s, and a table of contents for Volumes I-XI.

Jurisdiction.

The judgments of the court of appeals were entered on January 20, 1967 and were modified by an order on rehearing entered on April 18, 1967 (App. A, *infra*, pp. 1-3). On April 17, 1967, Mr. Justice White extended the time for filing a petition for a writ of certiorari on behalf of The City of Los Angeles to June 19, 1967. The City's petition was duly filed and certiorari was granted on June 12, 1967. Jurisdiction of this Court is invoked under 28 U.S.C. 1254(1) and 15 U.S.C. 717r(b).

Questions Presented.

1. Must the Federal Power Commission, under the Natural Gas Act (15 U.S.C. 717, *et seq.*), establish area gas rates to allow recovery of the industry's "cost of service" when according to the Commission such a cost of service would include expense items substantially in excess of the actual cost of the gas subject to the rate order?

2. Whether in view of this Court's decision in *Mobile*[2] and in *Sierra*[3] the Federal Power Commission's rate order is unlawful because it did not abrogate all producer contracts with prices below the applicable area rates found by the Commission to be just and reasonable to permit all producers to recover such rates?

3. Whether the Federal Power Commission need, at this time, in an area rate case establish detailed administrative procedures for individual producer relief, including provisions for a stay of the entire general rate order?

---

[2]*United Gas Pipe Line Co. v. Mobile Gas Corp.*, 350 U.S. 332 (1956).

[3]*Federal Power Com. v. Sierra Pacific*, 350 U.S. 348 (1956).

4. Where the Federal Power Commission has determined just and reasonable area rates, must area revenues exceed the allowable area cost of service before refunds of contract rates collected subject to refund under Section 4 of the Natural Gas Act may be ordered?

5. Whether the Federal Power Commission's Opinion No. 468 is a lawful and enforceable order of the Commission?

Statute Involved.

The statutory provisions involved are Sections 4 (15 U.S.C. §717c), 5 (15 U.S.C. §717d), and 19 (15 U.S.C. §717r) of the Natural Gas Act.

Statement.

This Court is already familiar with the background which led to the Federal Power Commission's first area rate decision, which has now been remanded by the Court of Appeals. It is recited in full in Mr. Justice Harlan's Opinion in *Wisconsin v. Federal Power Commission,* 373 U.S. 294, 295-302 (1963), hereafter referred to as *Second Phillips,* and the facts there set forth need not all be repeated here except to state that the Commission's decision had its genesis in *Phillips Petroleum Co. v. Wisconsin,* 347 U.S. 672 (1954).

This Court will recall that following the remand in *Phillips Petroleum Co., supra* (which charged the Commission with the duty to regulate rates charged by the natural gas producers), the Commission reinstated

its investigation of Phillips Petroleum Company's natural gas rates; and following extensive hearings, briefs and arguments, concluded:

> ". . . that the individual company cost-of-service method, based on theories of original cost and prudent investment, was not a workable or desirable method for determining the rates of independent producers and that the 'ultimate solution' lay in what has come to be known as the area rate approach: 'the determination of fair prices for gas, based on reasonable financial requirements of the industry' for each of the various producing areas of the country."[4]

Following its decision in *Second Phillips, supra,* the Commission set down its first area rate case on December 23, 1960. It was to encompass an oil and gas producing area known as the Permian Basin which the Commission characterized as "one of the nation's great oil and gas provinces."[5] This Basin is located in southeastern New Mexico and western Texas. It forms the most important natural gas supply area for southern California.

Los Angeles' need for effective producer regulation is unusually great. Its population of over 2½ million represents nearly one-half of the 6 million population in the Los Angeles Metropolitan Area. It represents a substantial part of the State, which is the largest in the Union, having a current population in excess of 19 million. It depends on natural gas as the basic source

---

[4]*Second Phillips, supra,* 373 U.S. 298-299.

[5]Opinion No. 468, p. 1 (J.A. 529d, R. 277567).

of residential and industrial energy. Not only is gas used directly for space heating, water heating, air conditioning and cooking, but it provides in large measure the energy used for generating electricity. Unlike other areas of the Nation, coal is not an economical alternative to natural gas for Los Angeles energy requirements for space and water heating. Also, the use of coal is prohibited by air pollution regulations. The use of oil is likewise prohibited, to the extent that gas is available for industrial use. Los Angeles is vitally interested in the outcome of this proceeding because about 65 percent of its total natural gas supply comes from pipelines whose major source of natural gas is in the Permian Basin area. Physically, nearly all the gas involved in this proceeding flows westward to markets in California or smaller markets along the way. This supply of natural gas, its price and the stability of that price are of critical importance to Petitioner and its residents as natural gas consumers.

Actual hearings in the Permian proceeding commenced on October 11, 1961, and concluded on September 12, 1963. Two hundred fifty-one hearing days were involved, and the hearing transcript covers 30,020 pages. Three hundred thirty-seven exhibits were introduced by the parties. The matter was then submitted to a hearing examiner of the Federal Power Commission who rendered his decision on September 17, 1964. Following briefs on exceptions, oral argument was heard by the full Commission beginning on February 8, 1965. On August 5, 1965, the Commission issued its opinion. Following petitions for rehearing, the Commission issued Opinion No. 468-A on October 4, 1965, denying applications for rehearing, but

modifying its initial opinion where it deemed appropriate. Los Angeles participated extensively in the proceeding.

On September 13, 1965, Skelly Oil Company petitioned for review by the Court of Appeals for the Tenth Circuit, and other respondent producers followed suit. Los Angeles intervened and actively participated by brief. On January 20, 1967, the Court of Appeals issued its opinion remanding the Commission's decision for further proceeding in accordance with that opinion. On petition for rehearing by a number of respondent producers, the Court of Appeals issued its Opinion (App. A *infra* pp. 1-3).

Summary of Argument.

1. The Court of Appeals has upheld the area method of regulation and the basic concepts in the Commission's Decision, except as to the questions raised herein. The remand by the court below now threatens long extensive delays in the first area proceeding to determine just and reasonable rates for natural gas producers. Such delay is not in the interest of the producers, nor is it in the interest of the public.

2.(a) Legal requirements of rate making do not dictate that area revenues equal the allowable area cost of service. The court below, in applying the end result test set down in the *Hope Case* [320 U.S. 591 (1943)] erred in its narrow view of the Commission's order, wherein it failed to view the order in its entirety in concluding whether it is just and reasonable.

2.(b) The rates established by the Commission in its order cannot be found to be so low as to result in confiscation, or even so low as be unlawful merely be-

cause the Commission did not make a specific finding that such rates would cover the "cost of service" which the Commission found exceeds the cost of gas.

2.(c) The Court of Appeals erred in applying the Sierra and Mobile decisions in suggesting that low contract rates must be raised to the area rate level in order to balance group revenues and group costs. There is no evidence in the record to substantiate the necessity for the Commission to raise contract rates which are below the area ceiling to levels above the 9 cents per Mcf determined to be the floor or minimum rate.

2.(d) There is no need at this time to establish detailed administration procedures for savings clause relief. To endorse the Court of Appeals mandatory stay of the general order is premature, would cause administrative havoc and would undermine area rate making.

3. The reversal by the Court of Appeals of its position with respect to the proper basis for making refunds in this case is unlawful. The reversed position of the lower court with respect to refunds would give the producers a most advantageous position to obtain and retain illegal gains.

ARGUMENT.

1. The Remand Ordered by the Court Below Would Result in Fruitless and Unnecessary Delay of Producer Regulation.

The Court of Appeals upheld the basic framework of the method of regulation adopted by the Commission. In doing so, it approved the area method of regulation, the two price system adopted by the Commission, the cutoff date proposed, and the moratorium on price increases, all essential to the effectiveness of the Commission's action. It nevertheless remanded to the Commission for further proceedings, the matters encompassed in our statement of questions presented.

The Commission has long struggled with the duty imposed upon it to regulate producer rates. The history of this struggle can be read in the decisions of this Court in the years since 1954 which have arisen from Commission action. And now, in this case, the Commission has come forward with the method of regulation which not only satisfies its conception of the requirements of the Natural Gas Act, but in large measure satisfies the requirements of the Court below.

The Commission's opinion opened with:

> "This is the first area proceeding to determine just and reasonable rates for natural gas producers. It is the culmination of an effort initiated more than four and a half years ago, and which has been carried forward with the greatest sense of urgency on the part of all concerned." 34 FPC at 171, J.A. 529d, R277, 568.

This sense of urgency was the result of the recognition by all concerned, including the Commission, that this case was the most important one to be heard by

the Commission since it was impressed with the duty to regulate the rates of independent producers. The interim efforts of the Commission in attempting to fulfill this duty have been heard by this Court. This decision is of far greater importance than the interim decisions already heard.

The effect of the Court's remand of the Commission's decision can best be described by the following quotation from this Court's opinion in *Second Phillips, supra.*

> "Such a remand undoubtedly would have consumed considerable time and energy, including that of the Commission and its staff, and would almost certainly have involved another decision by a hearing examiner, another appeal to the Commission, another petition for rehearing and further judicial review of complex and difficult issues. In short, the alternative rejected by the Commission would not have resulted in definitive regulation of Phillips' rates immediately or in the near future. Indeed, several years might have elapsed before even the method of regulation which the Commission regards as unsuitable would have become effective as to even this one producer." (373 U.S. at 311-312)

2. The Rate Order Adopted by the Commission Is Not Unlawful.

(a) The Hope End Result Test Does Not Require That Area Revenues Equal the Allowable Area Cost of Service.

The critical issue in this case is whether the Commission has complied with the legal requirements for rate making under the Natural Gas Act. The court be-

low concluded that the Commission failed to do so. Although the court recognized that "the Commission is not bound by any formula or method" in rate making under the Natural Gas Act, it concluded that the controlling standard for area rate making is the end result test set down in the *Hope* case. (App. B, pp. 400, 403, 412.) It rejected the Commission's determination that the end result test was satisfied by its finding that the rate order, when viewed in its entirety, established a fair relationship between the area rates prescribed by the Commission and the allowable cost of service for the area. The Commission's method involved consideration of composite cost data as a basic ingredient in area rate making, as well as other economic and policy factors, but it did not involve a specific finding that group revenues would balance group costs.[6] The lower court concluded that the Commission must, under the end result test, balance these costs and revenues. (App. B, pp. 411, 413.)[7]

The position taken by the court below fully adopts the producers' contention that once composite cost-of-service data are utilized in area rate making, the Commission must proceed as it would in an individual utility company cost-of-service proceeding. (App. B, pp. 428-29.) This position is erroneous because it inter-

---

[6]It should be recognized that "group costs" as used herein refer to the Commission's cost-of-service determinations for new and old gas-well gas. These cost-of-service determinations were used as yardsticks for the pricing of other types of gas. They include allowances for exploration, which may or may not be expended for this purpose. Certainly the term "costs" does not refer to costs which must be recovered in order to avoid confiscation and consequent denial of due process.

[7]Printed separately in Appendices to Petition for Writ of Certiorari.

prets the *Hope* end result test to be extremely rigid and narrow, thereby denying any flexibility to the Commission at all, and it grossly misunderstands the area rate concept by viewing it as no different from individual company cost-of-service rate making. The end result test does not require that group revenues balance group costs; nowhere in the *Hope* case has this Court said that this test can be satisfied only by computing this particular equation. On the contrary, *Hope* affirmatively states that no single formula is required to be used in rate making under the Act. 320 U.S. 591, 602.

The essence of the end result test is whether the Commission's order *"viewed in its entirety"* meets the requirements of the Natural Gas Act. While the court below relied on *Second Phillips* for applying the end result test to area rate making, it failed to follow this Court's explicit description in that decision of what this test involves:

> "But to declare that a particular method of rate regulation is so sanctified as to make it highly unlikely that any other method could be sustained would be wholly out of keeping with this Court's consistent and clearly articulated approach to the question of the Commission's power to regulate rates. It has repeatedly been stated that no single method must be followed by the Commission in considering the justness and reasonableness of rates, *Federal Power Comm'n v. Natural Gas Pipeline Co.*, 315 U.S. 575; *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591; *Colorado*

Interstate Gas Co. v. Federal Power Comm'n, 324 U.S. 581, and we reaffirm that principle today. As the Court said in *Hope:*

> 'We held in *Federal Power Commission v. Natural Gas Pipeline Co., supra,* that the Commission was not bound to the use of any single formula or combination of formulae in determining rates. Its rate-making function, moreover, involves the making of 'pragmatic adjustments.' *Id.,* p. 586. *And when the Commission's order is challenged in the courts, the question is whether that order 'viewed in its entirety' meets the requirements of the Act. Id., p. 586. Under the statutory standard of 'just and reasonable' it is the result reached not the method employed which is controlling.'* 320 U.S., at 602.
>
> More specifically, the Court has never held that the individual company cost-of-service method is a *sine qua non* of natural gas rate regulation. Indeed the prudent investment, original cost, rate base method which we are now told is lawful, established, and effective is the very one the Court was asked to declare impermissible in the *Hope* case, less than 20 years ago." (373 U.S. 309; emphasis added.)

This passage clearly demonstrates that the Commission does not have to use one particular formula or equation, and that the end result test is made by viewing the Commission's order in its entirety to see if it is just and reasonable as required by the Act. The lower court has misunderstood the *Hope* case by transforming the flexible end result test into a rigid and nar-

row method consisting of no more than the revenues-must-equal-costs equation. It says, in effect, that only this equation satisfies the end result test, and this equation must show revenues equal costs or the rate order falls. This view is in direct conflict with *Hope* and the passage above from *Second Phillips* and the other cases cited therein.

Moreover, this rigid interpretation of the end result test is contradictory not only to the Commission's concept of area rate making but also to this Court's preliminary view of it in *Second Phillips*. In that case this Court stated that area rate making involves consideration of economic factors of the industry and not merely strict adherence to the revenue-cost equation. This Court quoted the statement by the Commission in Opinion No. 338 that it intended to set rates "based on 'the reasonable financial requirements of the industry' in each production area." (373 U.S. 294, 310). This statement demonstrates that this Court understood and approved of the Commission's intention to consider economic factors other than cost.[8]

Nevertheless, the court below emphasized that it rejected the Commission's "fair relationship" interpretation of the end result test because it was not told what economic factors "either require or permit departure from costs and revenues." (App. B, p. 429.) In taking this position, the lower court does not evaluate or even mention the various factors which the Commission said

[8]See also footnote 16, 373 U.S. 294, 310, where this Court announced that it did not interpret the decision of the Court of Appeals for the District of Columbia in *City of Detroit v. Federal Power Commission*, 230 F. 2d 810 (D.C. Cir. 1955), "to suggest that, in the view of that court, individual company cost of service is the method required to be used in independent natural gas producer rate regulation."

it did consider, such as: (1) that area rate making differs from individual company cost-of-service rate making in that it does not involve the costing of all gas, but instead, the costing of old gas-well gas as the yardstick to set the price for oil-well gas on a commodity value basis because this gas is a by-product of oil production and, as a result, its cost could not be accurately determined. (J.A. 574d, 614d-624d);[9] (2) that some 9.0 cents of the 14.5 cents price for flowing gas was partly based on non-cost factors with the purpose of meeting the producers' "revenue deficiency" argument (J.A. 1112d-1114d); (3) that the producers would receive additional revenues than merely those permitted by the Commission's rates because of certain contract provisions and because of the extraction of liquid hydrocarbons (J.A. 1112d-1115d); (4) that the Commission substantially reduced the amount of the downward price adjustments due to quality deviations (J.A. 1115d-1116d); and (5) that the Commission took into account that its rates should avoid abrupt departures from existing pricing patterns in order to avoid business dislocation (J.A. 573d-574d). At the very least, the court below should have given consideration to these factors in evaluating the Commission's decision. The lower court having failed to do so, the Commission is the victim of obscurity in that it has not been told why these factors are not sufficient to justify its finding of a fair relationship between revenues and costs.

Finally, the court below has refused to give the Commission any deference for its judgment and discretion as a federal administrative agency in possession of

[9]While the cost of oil-well gas could not be determined precisely, the Commission specifically found that its cost was substantially below the cost of old gas-well gas (J.A. 1112d).

expertise in the matters under its jurisdiction. *Securities and Exchange Commission v. Chenery Corporation,* 332 U.S. 194, 207-8 (1947). It is clear that where rate making is involved some findings of regulatory bodies are proper without detailed explanations or even any supporting evidence. *Market Street Railway Company v. Railroad Commission,* 324 U.S. 548 (1945); 2 Davis, Administrative Law, 471-2 (1958). But the lower court has rejected, without any discussion, the various economic factors relied upon by the Commission in determining area rates.

(b) There Has Been No Showing That the Commission's Rate Order Will Not Permit Revenues Adequate to Recover the Producers' Actual Costs of Gas Sold.

The Court below, in the absence of any showing that the actual cost of the gas being sold by the producers exceeded the allowed rates, either individually or as a group, concluded that the rate order was unlawful because the Commission did not specifically find that its applicable rates, including quality adjustments, would recover the total "cost of service" of the producers as a group. The "cost of service" includes not only the cost of production but also the cost of finding new reserves and additional reserves to meet estimated future demands. The Commission in discussing these items of cost said in respect to the bulk of the gas subject to the rate order:

> "While the cost of residue gas cannot be found with the precision requisite to serve as a basis for fixing ceiling prices, the evidence in the record makes clear that with respect to casinghead gas and residue gas derived therefrom (which together make up by far the largest share of the Per-

mian gas subject to quality adjustments) the costs are substantially below the 14.5 cents per Mcf ceiling price. For one thing the price includes a 4.08 cents allowance for exploration and development expense even though such gas was largely found as a by-product of the search for oil. For another, there would be no reason to allow producers a 12 percent rate of return on their investment for processing residue gas since the investment in processing plants and equipment is subject to few of the special risks incurred by those who explore for and develop reserves of gas.

"We do not meaan to suggest that the E&D allowance and the profit which we have provided for flowing gas is not fully justified, but we believe it is relevant to point out that these two items, which account for 9.0 cents of the 14.5 cents price for flowing gas, are based in part on justifications other than cost, and provide ample allowance for the risk that low-quality gas in the area may not command the full area price." (Opinion No. 468A, p. 6; J.A. 1112d-1113d, R278, 709-R278, 710)

The court below completely ignored the above finding and statement of the Commission and ignored its own following observation:

"We agree with the Commission that the expense items included in an individual cost-of-service are not the measure of a confiscatory rate. A producer has no constitutional right to be reimbursed for dry-hole expenses. Also it has no obligation to remain in business by replenishing the supplies of gas which form the basis of present obligations.

> Inability to continue exploration and development is not confiscation. We conclude that the impact of the Permian rates on the high cost producers does not destroy the area rate method." (Appendix B, p. 416-417.)

Not only has there been no showing of confiscation, but the record before the Commission and above quoted statement of the court below establishes that rates fixed on the basis of "cost of service" are above the actual costs of gas sold.

We do not mean to suggest, as the Commission in the above quotation did not mean to suggest, that it is either improper or not in the public interest to provide for an adequate exploration allowance to replace gas sold and obtain additional reserves. However, we do suggest that the rates established by the rate order cannot be held to be unlawfully low merely because the Commission did not specifically find that such rates would permit the recovery of revenues adequate to cover a "cost of service" which, the Commission said, substantially exceeds the actual cost of the gas subject to the order.

There was no showing that the rate order was confiscatory, there was no showing that the rate order was unjust and unreasonable in its consequences, and the Commission found precisely to the contrary on substantial record evidence.

It is our view that the Commission satisfied the *Hope* "end result" test; and indeed it is more than apparent that this was its goal in Opinion 468.

(c) The Court of Appeals' Decision Is Incompatible With This Court's Pronouncements in the Sierra and Mobile Cases.

The Court of Appeals' decision is in clear conflict with this Court's decisions in *Sierra*[10] and *Mobile*.[11] The Court of Appeals implies that in testing to determine whether the revenue requirement of the industry is being satisfied so as to meet the *Hope* test, the Commission must take into consideration and compensate for revenue deficiencies caused by contractual price restrictions the producers have contractually bound themselves to.

This Court, in *Sierra,* held that contractual obligations cannot be upset by a regulatory agency unless there is a finding that the public interest requires it. The Commission can increase the contract rate only when it is so low as to adversely affect the public interest.

> "In such circumstances the sole concern of the Commission would seem to be whether the rate is so low as to adversely affect the public interest —as where it might impair the financial ability of the public utility to continue its service, cast upon other consumers an excessive burden, or be unduly discriminatory." 350 U.S. at 355.

The Commission's Opinion No. 468 found that the public interest did require a floor or minimum rate. It set this rate at 9 cents per Mcf. It did not find that the public interest required that the area rate be raised to compensate for low contractual commitments, nor

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[10] *Federal Power Com. v. Sierra Pacific, supra.*

[11] *United Gas Pipeline Co. v. Mobile Gas Corp., supra.*

did it find that rates in excess of 9 cents, but below the area ceiling, should be raised to the area ceiling to insure that revenues will balance costs. For the Commission to have done so would have been error, for there is no evidence in the record to sustain such a result.

The court below seems to suggest that the minimum rate be raised in order to make group revenues equate to group costs. Any such action would be directly contrary to the *Sierra* decision.

Unfortunately, the opinion of the court below is ambiguous on this point. While noting that "the producers are not entitled as a matter of right to collect contract rates that are higher than otherwise reasonable in order to offset other rates limited by contract to below maximum reasonable levels" and that "contract limitations are one of the facts of life for the natural-gas industry" (App. B, p. 424), it expressed concern over the revenue deficiency resulting from these contract limitations, and it noted that in group procedures before the Interstate Commerce Commission "revenue from one source may balance that from another" (App. B, pp. 423-24). The lower court's discussion of this matter ends with the statement that "the controlling question is whether the proper revenue requirements of the area producers as a group can be satisfied with rates having the ceiling and the floor which the Commission has fixed" (App. B, p. 425). This language suggests that the minimum rate would be rejected or raised if the court concluded that the "proper revenue requirements" were not "satisfied." Significantly, the lower court concluded that it cannot answer this question because the revenue-cost equation has not been provided.

Whatever the lower court's opinion may mean with regard to this matter, there can be no doubt of the unlawfulness of raising the minimum rate to or near the just and reasonable rate in order to balance group revenues and group costs. This view is contrary not only to the *Sierra* case, but also to *Federal Power Commission v. Tennessee Gas Transmission Company,* 371 U.S. 145 (1962), which held that losses in one zone of operations do not justify an illegal gain in another zone. If the court below is correct in viewing area rate making as only another instance of individual company cost-of-service rate making, then certainly it cannot ignore the *Sierra* and *Tennessee* cases by relieving the producers from their voluntarily made low contract rates.

The Court of Appeals implies that low rates must be raised to the area rate without the requisite finding that the contract rate is so low as to affect the public interest. This, we submit, misreads *Sierra* and *Mobile.* The Court of Appeals' holding should not be permitted to stand.

(d) The Court of Appeals' Suggestion Regarding the Savings Clause Is Premature and Would Create Administrative Havoc.

Another error is the Court of Appeals' position on the savings clause—that clause which the Commission inserted in its decision to allow special relief when the public interest or constitutional considerations so required. The Court of Appeals found the Commission's provision "vague and nebulous." It said:

> "An adequate savings clause should contain guidelines which if followed by an aggrieved producer

> will permit it to be heard promptly and to have a stay of the general rate order until its claim for exemption is decided."[12]

The court below seems to conclude that the Commission intended to grant relief only from confiscation. (App. B, p. 419.) Such a conclusion is clearly erroneous. The Commission did not limit the basis for invoking the special relief procedure to claims of confiscation; it specifically stated that "there may be other circumstances where a producer as a matter of law or in the public interest would be entitled to some relief" (J.A. 658d). Obviously when the Commission has only begun the task of establishing a new concept such as area rate making, it cannot now foresee all possible relief situations.

The relief provision was designed to provide notice that relief would be available. For practical reasons, the Commission did not attempt to foresee all the possible factual situations justifying special relief, nor did it spell out in detail what the relief would be. These specifics obviously could be provided when the time for such relief arose. The court below, however, characterized this provision as "inadequate" and said that an adequate relief provision would "contain guidelines which if followed by an aggrieved producer will permit it to be heard promptly and to have a stay of the general rate order until its claim for exemption is decided." (App. B, p. 419.) In addition, the lower court seems to say that individual costs should be the basis for relief. (App. B, p. 419.) This position would mean a return to individual cost of service.

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[12]Appendix B, page 419.

In directing that each producer be entitled to a stay from the Commission's rate order, the lower court provides the means to undermine area rate making through numerous stays pending relief. The Commission could be deluged with hundreds of petitions for relief. No such right to a stay was required by this Court in the *New England Divisions* case, 261 U.S. 184 (1923), in which the Interstate Commerce Commission's rate order became effective immediately, subject to later adjustment if a proper showing was made. As in that case, there is no reason for an automatic stay from area rates; the general rule should prevail that stays will be granted only upon a showing of irreparable injury to the producer concerned. The mere possibility that a producer is entitled to special relief from area rates does not justify the continuance of collecting rates which have been held to be too high. *Federal Power Commission v. Tennessee Gas Transmission Company*, 371 U.S. 145, 151-2, 154 (1962); *United Gas Improvement Company v. Callery Properties, Inc.*, 382 U.S. 223 (1965).

It would be highly inappropriate to remand this important case for the purpose of establishing administrative procedures for savings clause relief. The lower court's concern regarding the detailed operation of the savings clause is premature. The appropriate time for judicial review of administrative procedures involving the savings clause would arise at such time as a producer seeks savings clause relief and is denied such relief as a result of procedural or substantive error on the part of the Commission. Further, the blanket mandatory "stay of the general order" suggested by the Court is judicially unique—traditionally, stays have

been granted on the basis of the particular circumstances of each case. Adoption of the lower court's stay requirement would lead to administrative chaos completely frustrating effective area rate making.

3. The Reversal by the Court Below of Its Original Position on the Refund Question Is Erroneous.

The court below has completely reversed itself on the question of the proper basis for refunds in an area rate proceeding. The court originally said that it "saw no escape that refunds be on an individual company basis and on a schedule by schedule basis" and that if confiscation would result or the public interest would be harmed by any refund obligation the answer was an adequate special relief provision (App. B, pp. 426-27). Now the court says that refunds must be made on an industry area wide basis, thereby permitting refunds only if group area revenues exceed group area revenue requirements.

It is submitted that the lower court's new position is unlawful. The court's conclusion that *Federal Power Commission v. Tennessee Gas Transmission Company*, 371 U.S. 145 (1962), is no longer applicable because it dealt with zone rates is grossly inaccurate. That case announced fundamental and permanent principles regarding refunds under Section 4(e) of the Natural Gas Act, and it cannot be brushed aside on its facts. 371 U.S. 145, 152-3. The lower court would permit individual producers who have assumed the hazards involved in the Section 4 procedure to retain any illegal gain (i.e., that portion of rates which exceeded the Commission's just and reasonable area rates and which were collected subject to refund) in the name of bal-

ancing group revenues with group revenue requirements. Such a result leaves produces in the best of all worlds—refund determinations made on a group basis and special relief determined on an individual basis. In addition, such a result is contrary to this Court's firm statement that regulation does not guarantee a profit. *Federal Power Commission v. Natural Gas Pipeline Company*, 315 U.S. 575, 590 (1942). It also violates this Court's decision in *Hope* by permitting an end result totally unfair to consumers.

Likewise, the lower court's reliance upon *Second Phillips* to justify its change of position is misplaced. The Commission decision in that case did not hold that increased rates collected subject to refund, which were higher than the subsequently determined just and reasonable rate, cannot be refunded because company overall costs exceeded revenues for the test year. This Court expressly recognized in *Second Phillips* that the Commission had not made any determination of just and reasonable rates for the company because the Commission had found the individual company cost-of-service method was not adequate for producers. 373 U.S. 294, 306 n. 15. This Court approved the Commission's termination of a limited number of consolidated rate increase proceedings for locked-in periods on the ground that it was not worth the time and cost to determine reasonable rates for certain past periods, and then determine the refunds required.

Conclusion.

"[T]o Afford consumers a complete, permanent and effective kind of protection from excessive rates and charges,"[13] which congress promised and this court affirmed, immediate action is needed by this court in reversing the judgment below and affirming the Decisions of the Commission.

Respectfully submitted,

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[13] *Atlantic Refining Co. v. Public Service Com.*, 360 U.S. at 388.

APPENDI

APPENDIX A.

UNITED STATES COURT OF APPEALS
TENTH CIRCUIT

MARCH TERM, 1967
[April 18, 1967]

Nos. 8385 etc.

SKELLY OIL COMPANY, ET AL., PETITIONERS

v.

FEDERAL POWER COMMISSION, RESPONDENT

On rehearing.

Per Curiam.

Texaco Inc. asserts that the opinion is not clear as to the disposition of its Docket No. C161-879 in which, by an order separate and apart from Opinions Nos. 468 and 468-A and their accompanying orders, a § 7 certificate was issued at a rate of 14.5 cents less quality deductions. This separate order shows that the Commission treated the area rate as the in-line rate for § 7 certificates.

The order on this docket was lost in the mass of material presented to us. No party made a point of it. We have reconsidered the Texaco petition for review and have concluded that it is sufficiently broad to cover such order. It should receive the same treatment as the § 4 and § 5 proceedings. Accordingly, the remand includes the separate order entered in Docket No. C161-879.

We note that in its disposition of this particular docket the Commission took the position that an established area rate automatically becomes the in-line rate for a § 7 proceeding. The same position was taken by the Commission in its Opinion No. 484 which we are today reversing by our decision in Nos. 8723 etc.—Phillips Petroleum Company, et al. v. Federal Power Commission,—F.2d—. We there hold that in a § 7 application heard by the Commission after its Permian decision the adoption of the area rate as an in-line rate must fall because we have rejected the area rate. We do not there, and we do not here, express either approval or disapproval of the principle that an area rate established in a § 5 proceeding automatically becomes an in-line rate for a § 7 proceeding. The validity of such a principle may be affected by the final determination of the validity of the Permian Basin area rate.

Various producers insist that we erred in our treatment of refunds. We held that refunds must be on a company-by-company and schedule-by-schedule basis. We are now convinced that such holding was wrong and is inconsistent with our conclusion that satisfaction of the end result test requires rates which will equate group revenues with group revenue requirements.

The refunds in question relate to collections made during the so-called "locked-in" periods, i.e., the periods during which an increased rate, later superseded by a further increase, is effective. See Second Phillips, 373 U.S. 294, 298, fn. 5. In that case the Court said that on the locked-in rate issue "the sole question was whether all or any part of the increases had to be refunded by Phillips." The Court pointed out that the

Commission decided that the increases did not bring revenues up to cost of service, and held that the Commission "properly concluded" that "no refund obligations could be imposed." *Id.* at 306.

We are now convinced that this treatment of refund obligations for locked-in rates in the case of an individual company in Second Phillips must be applied on a group basis when an area rate is fixed and tested by the end result. We are also convinced that our reliance on Federal Power Commission v. Tennessee Gas Transmission Co., 371 U.S. 145, was misplaced. That case dealt with zone rates. The Second Phillips decision on locked-in rates came later.

This modification of the opinion means that no refund obligation may be imposed for a period in which there is a group revenue deficiency. When group revenues exceed group revenue requirements, refunds may be ordered on some equitable contract-by-contract basis. In fixing an area rate, the Commission must consider the effect which past and potential refunds have on the balancing of group revenues with group revenue requirements.

In all respects, except those specifically noted herein, the petitions for rehearing are severally denied.

JOINT BRIEF

Nos. 90, *et al.*

AUG 25 1967

JOHN F. DAVIS, CLERK

In the

Supreme Court of the United States

OCTOBER TERM, 1967

PERMIAN BASIN AREA RATE CASES

On Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

Joint Brief of California Gas Distributors

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Nos. 90, *et al.*

In the

Supreme Court of the United States

OCTOBER TERM, 1967

PERMIAN BASIN AREA RATE CASES

On Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

Joint Brief of California Gas Distributors[1]

OPINIONS BELOW

The decision of the hearing Examiner in the Permian Basin Area Rate cases is reported at 34 F.P.C. 306 (1964). The opinions and orders of the Federal Power Commission (hereinafter "Commission") are reported at 34 F.P.C. 159 (1965), 34 F.P.C. 424 (1965), 34 F.P.C. 1068 (1965), and 34 F.P.C. 1082 (1965). The opinion of the United States Court of Appeals for the Tenth Circuit, including its opinion on rehearing, is reported at 375 F.2d 6 (10th Cir. 1967).

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1. Consisting of petitioners Pacific Gas and Electric Company, Pacific Lighting Service and Supply Company, San Diego Gas & Electric Company, Southern California Gas Company, and Southern Counties Gas Company of California.

JURISDICTION

The judgments of the Court of Appeals setting aside the Commission's order were entered on January 20, 1967. These judgments were modified by an order on rehearing entered on April 18, 1967. On April 19, 1967, these petitioners timely filed their petition for certiorari, and on May 5, 1967, a motion to file a supplement to petitioners' petition for certiorari was filed adding issues raised by the Court of Appeals' order on rehearing. Certiorari and the motion to supplement petitions for certiorari were granted on June 12, 1967 [..... U.S. ..... (1967)]. The jurisdiction of this Court rests on 28 U.S.C. 1254(1) and Section 19(b) of the Natural Gas Act, 15 U.S.C. 717r(b).

QUESTIONS PRESENTED

1. Must the Commission, under the Natural Gas Act (15 U.S.C. § 717, et seq.), establish area gas rates to allow recovery of the yardstick "costs of service" employed by the Commission in setting such rates when the Commission found on substantial evidence that such yardstick costs of service substantially exceeded the actual cost of the gas subject to the rate order?

2. Whether in view of this Court's decisions in *Mobile*[2] and *Sierra*[3] the Commission's rate order is unlawful because it did not abrogate all producer contracts with prices below the applicable area rates found by the Commission to be just and reasonable to permit all producers to recover such rates?

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2. United Gas Pipe Line Co. v. Mobile Gas Service Corp., 350 U.S. 332 (1956).

3. Federal Power Com. v. Sierra Pacific Power Co., 350 U.S. 348 (1956).

3. Whether the Commission need, at this time, in an area rate case establish detailed administrative procedures for individual producer relief, including provisions for a stay of the entire general rate order?

4. Whether the Commission's Opinion No. 468 is a lawful and enforceable order of the Commission?

5. Can the Commission in a Natural Gas Act Section 7 (15 U.S.C. § 717f) initial certificate proceeding involving producer rates adopt as the in-line rate its most recently determined applicable just and reasonable area rate?

6. Can the Commission in an area rate order require individual producers to refund rates in effect subject to refund to the extent that they exceed the applicable area rate?

STATUTES INVOLVED

The pertinent provisions of the Natural Gas Act, 15 U.S.C. § 717-717w, are reproduced in the Appendix of the Brief for the Federal Power Commission, which is being filed concurrently, and are incorporated herein by reference.

STATEMENT

This is the most important Commission decision to reach appellate review since this Court charged the Commission with the duty to regulate producer prices in *First Phillips.*[4] It is vitally needed to assure some semblance of stability and direction to producer pricing and regulation under the Natural Gas Act (15 U.S.C. §§ 717, et seq.).

Not only is this case of national importance as far as the gas industry is concerned, but it is of particular importance to gas consumers in California, who have come to rely on increasing amounts of out-of-state gas.

In 1960, the California Gas Distributors obtained more than 65 percent of their total natural gas supply from pipelines whose major source of supply is purchased in the Permian Basin area. Physically, most of the gas sold in interstate commerce by independent producers in the Permian Basin flows westward to markets in California or smaller markets along the way. (R. Vol. X, 536d)

As California's reliance on Permian gas increased, the price of that gas escalated dramatically. El Paso Natural Gas Company, the principal pipeline purchaser in the area, paid an average purchase price of 2.8 cents per Mcf in 1947; by 1960 this average purchase price had risen to 13.8 cents per Mcf for an increase of 493 percent. (R. Vol. VI, 179e) The weighted average *initial* price in new long term contracts for the sale of Permian gas rose from 12 cents per Mcf in 1953 to in excess of 18 cents per Mcf by 1958 with a significant number of new purchase contracts exceeding 21 cents per Mcf. (R. Vol. VI, 122e)

When the Commission embarked upon its area-wide method of establishing reasonable, just and administratively feasible rates, it moved with commendable caution. It did

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4. Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672 (1954).

not predetermine the method or techniques to be employed in setting rates. Instead, it convened this case and announced that the first body of evidence which it desired to be given careful consideration was that concerning the economic characteristics of the producing industry. The hearings were thus divided into two phases—the first dedicated to economic evidence and the second to cost evidence.

Certain basic economic characteristics of the natural gas producing industry were established in the hearings. Among the factors developed were:

1. the industry was now, to a substantial degree, able to direct its search toward finding either gas or oil (R. Vol. I, 56, 58-59; Vol. IX, 150d-153d),

2. the principal future source of supply will be gas-well gas, neither found in a search for oil nor produced in association with it (R. Vol. I, 307-308; Vol. IX, 170d),

3. most of the currently flowing gas in Permian was found as a result of the search for oil (R. Vol. I, 56; Vol. IX, 138d), and

4. the cost of finding and producing gas rose to 1958, remained stable until 1960 and declined slightly thereafter (R. Vol. IX, 84d-85d, 170d-173d; Vol. X, 571d, Vol. X, 627d).

These factors became the foundation for the recommendation of a two-price system which was adopted both by the Examiner and the Commission.

a. The Rationale of the Two-Price System

The most important factor considered was the proof that the industry had reached the point where it could direct its exploratory effort toward finding either gas or oil.

If, as a matter of fact, producers could direct their

search toward gas as distinguished from oil, the recommendation of Mr. Justice Jackson of using price as a tool[5] could be followed by allowing an appropriate *incentive* price for new gas-well gas in order to produce enough gas to supply future needs of consumers.

On the other hand, gas produced in association with oil would be non-responsive to an increased gas price since such gas would respond only to increased prices for oil. Furthermore, no useful economic purpose would be served by paying a supply eliciting incentive price for gas already flowing from existing reservoirs. It would be sufficient and equitable to insure that producers were returned their actual expenses of finding and producing the gas, plus an adequate return.

The incentive price should, therefore, be limited to gas that would respond to the incentive—the yet to be discovered gas-well gas.

The Commission found that the most effective and efficient way to use price as a tool to elicit the required supplies of new gas is to separately reward the finders of new gas-well gas when the gas is found and devoted to the market. The Commission recognized that it would be an unwarranted gamble of consumer-supplied money to make an anticipatory payment to producers of old gas in the hope that they would use these funds, which exceeded by a substantial margin the cost of finding and producing the old gas, to find new supplies of gas. As the Examiner stated:

> "[T]his high price would not serve to any great extent to elicit new supplies of gas well gas, because pro-

5. "It will use price as a tool to bring goods to market—to obtain for the public service the needed amount of gas. Once a price is reached that will do that, there is no legal or economic reason to go higher; and any rate above one that will perform this function is unwarranted." [Colorado Interstate Gas Co. v. F.P.C., 324 U.S. 581, 612 (1945)]

ducers receiving this high price for all flowing gas would be free to reinvest it in oil, chemicals or real estate." (R. Vol. IX, 175d)

The two-price system was originally advocated in this case by Economist Alfred E. Kahn. The distinction between the two price levels was expertly set forth by Dr. Kahn when he said that the two-price system:

". . . attempts to hold down prices on old gas, where higher prices fulfill a lesser economic function and confer windfalls, while recognizing the incentive effects of higher prices on new contracts, possibly reflecting also the higher money costs of recent years." (R. Vol. II, 608)

Dr. Kahn pointed out that when Congress desired to provide an incentive for new investment, it adopted a similar method in the Federal 7 percent investment tax credit, whereby new equipment purchasers qualified for the credit, but existing equipment owners did not. He described the similarity:

"The logic of this plan is identical to the logic of the two-price system which I propose here. It is so framed as to maximize the incentive and minimize the windfall." (R. Vol. II, 609)

Thus, the Commission adopted a two price system with (a) one price for new gas-well gas based on the *current* cost of finding and producing that gas and (b) another price for all other gas based on the *historical* cost of finding and producing flowing gas-well gas. These were 16.5 cents and 14.5 cents, respectively, including Texas production tax. The flowing gas-well gas price was applied to new casinghead gas and residue gas derived therefrom since this gas was produced in association with oil and would, therefore, not respond to an incentive price for gas.

b. The Yardstick Costs Used in Setting the Two Ceiling Prices

The Commission chose cost estimates as pricing yardsticks for flowing gas and new gas that exceeded the costs developed by its Staff for each of the categories of flowing gas produced in Permian:

(1) The Yardstick for Flowing Gas

The Staff placed in evidence a series of studies based upon the composite responses by producers to a Commission cost questionnaire. These composite cost of service studies were constructed for the test year 1960, and they developed the average cost per Mcf for the several categories of gas. These were as follows:

Casinghead Gas	9.00¢[6]
Gas-well Gas	11.95¢[6]
Residue Gas	11.05¢[7]

These Staff studies included a return allowance of 9.5 percent and thereby reflected the cost of service for *average quality gas.*[8] Therefore, the above table demonstrates that the record contains substantial evidence that the producers weighted average cost for the test year was less than 11.95 cents per Mcf for *average quality flowing gas.*

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6. R. Vol. VII, 540e.

7. The Staff had originally developed a cost for residue gas of 14.46 cents per Mcf by using a method of allocating costs between gas and liquids. However, in its Brief on Exceptions, the Staff modified its figure to 11.05 cents per Mcf. (R. Vol. X, 404d) The modification was based on the Examiner's criticisms of the earlier Staff method. The Examiner's principal modification of the Staff's method involves the use of an economic factor in weighting the allocation of joint costs. (R. Vol. IX, 337d-339d). In finding that the cost of residue gas is lower than that of flowing gas-well gas, the Commission referred to the Staff's acceptance of the Examiner's modifications. (R. Vol. XI, 1116d)

8. As discussed below the Commission included a 12 percent rate of return allowance to compensate for the risk of not finding pipeline quality gas. It thus estimated the "cost" of pipeline quality gas.

The Staff's composite cost of service study for gas-well gas (revised to include an allowance of 12 percent return to compensate for the exploration risk and the risk of not finding higher quality pipeline gas) was adopted by the Commission as its pricing yardstick for all flowing gas, and new casinghead and residue gas derived therefrom, of *pipeline quality.*

This cost came to 14.39 cents per Mcf (R. Vol. X, 639d), which the Commission rounded up to 14.5 cents per Mcf.

(2) The Yardstick for New Gas-Well Gas

The Commission set a separate ceiling price for pipeline quality new gas-well gas and residue gas derived therefrom because, as shown above, the evidence established that (a) future supplies of gas will come primarily from gas-wells and not as a by-product from oil wells and the exploration for oil, and (b) such new gas-well gas will be elicited only if there is a price incentive sufficient to cover anticipated costs.

The Commission adopted as its yardstick cost for such gas, the estimated current cost of exploring for, developing and producing gas-well gas based, with slight modification, on a study introduced by the California Gas Distributors. (R. Vol. X, 576d) This estimate included all of the costs associated with producing and finding gas to replace that produced (including costs expended for unsuccessful wells) and obtain additional reserves to meet future demands. (R. Vol. X, 579d)

The Commission selected a ceiling price of 16.5 cents per Mcf for new gas-well gas of pipeline quality and residue gas derived therefrom.

c. Additional Features of the Rate Order

The Commission established quality standards for pipeline quality gas and provided for upward and downward

price adjustments for Btu content. Downward adjustments were to be made for such quality deficiencies as low delivery pressure, excessive sulfur and excessive water. (R. Vol. X, 645d, *et seq.*)

Then to insure that its order would not be confiscatory in respect to any individual producer the Commission added a savings clause establishing a general procedure which would allow a producer, under appropriate circumstances, to seek individual relief. (R. Vol. X, 656d, *et seq.*)

Next, the Commission ordered appropriate refunds of all rates placed into effect under Section 4(e) of the Natural Gas Act which were subject to refund. The refunds were ordered made on a rate schedule by rate schedule basis. That is, any portion of a rate collected subject to refund which exceeds the applicable area rate was to be refunded. (R. Vol. X, 672d, *et seq.*)

To protect the consumer and to give some meaning to the extensive years of hearing and decision making, the Commission also provided for a moratorium for a brief 2½ year period so that the rates set in the lengthy hearing would not be immediately breached following the Commission's decision. (R. Vol. X, 662d, *et seq.*)

SUMMARY OF ARGUMENT

The Commission's order which is based on substantial evidence should be affirmed *in toto*. Attacks on the decision for alleged failure to meet the "end result" test of *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944) are without merit.

There was no need for the Commission to arithmetically balance estimated costs with estimated revenues because:

(1) the law does not require such an arithmetic balance. *Federal Power Commission v. Hope Natural Gas Co., supra; Chicago and N.W.R. Co. v. A.T: and S.F.R. Co.,* ..... U.S. ....., 18 L.ed2d 803 (1967),

(2) the yardstick costs on which the Commission based its rate greatly exceeded the *actual cost* of the gas sold under the rate order, and

(3) there has been no showing of unjustness or unreasonableness, nor of confiscation. Indeed, the Commission included cost items it was not required by the Constitution to include and the rate was, therefore, substantially above the confiscation level.

Furthermore, the Commission provided a savings clause to insure that there would be no confiscation.

Additionally, the Commission's procedures for refunds, and moratorium on any rate increases for a reasonable period of time, are essential to an implementation of area regulation. [*Atlantic Ref. Co. v. Pub. Serv. Com. of New York*, 360 U.S. 378 (1959)]

Common sense requires the adoption of the area rate the Commission had just found to be just and reasonable as the in-line rate for sales temporarily certificated and consolidated with the area proceeding for permanent certification.

ARGUMENT

I

The Commission's Order Is Supported by Substantial Evidence—Reargument of the Evidence Is Inappropriate

The producers before the court below reargued their version of the evidence which had been rejected by the Commission. We anticipate that they will do the same here. The Opinions of the Examiner and the Commission each contain an exhaustive analysis of the evidence and the economic factors involved.

It seems wholly unnecessary for us to here recite, analyze, weigh and argue the evidence. That was done, first, before the Examiner and then before the Commission. This Court, as we see it, is not the proper forum for such an endeavor.

We here restrict ourselves to pointing out, where necessary, as we have in the statement and will hereinafter in the argument, the substantial evidence which supports the factual determinations in the Commission's rate order.

II

The Commission's Rate Order Was Based Upon a Reasonable Method Employing Substantial Evidence Reasonably Assumed to Reach a Just Result and Is Therefore Lawful in the Absence of a Convincing Showing That It Is Unjust and Unreasonable in Its Consequences

The basic question of the lawfulness of the Commission's order seems to have been somewhat obscured by the direction of the arguments before the court below. Those supporting the Commission's decision, including these petitioners, have consistently contended that it meets the end result test of *Hope*.[9] On the other hand, the producers argue that the record does not establish the arithmetic end result (i.e., that the revenues at the ceiling rates will cover estimated costs) and that it is, therefore, unlawful.

The court below seems to have accepted the producers contention. It held that it could not arithmetically balance the Commission's yardstick costs with revenues because the effect of the adjustments for quality was not precisely determined by the Commission from the evidence. Therefore, held the court below, the *Hope* test was not met and the rate order was unlawful. In so holding, the court below made two fundamental errors: (1) It misread the teachings of *Hope*, and (2) It erroneously assumed that the yardstick costs were the actual costs of the gas sold.

Hope does not hold, and this Court has never held, that the arithmetic end result must be shown in support of all Commission rate orders. *Hope* merely holds that *if the end result* is just and reasonable, then judicial inquiry is at an end. If the method employed in establishing a rate order is reasonable in the light of the case and can reasonably be assumed to provide just results, the rate order, in the

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9. Federal Power Com. v. Hope Natural Gas Co., 320 U.S. 591 (1944).

absence of a positive showing of confiscation, is lawful.

As held by this Court in *Hope*:

> "If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at an end." (320 U.S. at 602)

The producers would reduce this rule to a rigid formula under which it must be demonstrated by specific numbers that estimated revenues will cover estimated costs. This is, of course, a great paradox because the producers contend on one hand that costs cannot be determined with precision and then proceed to argue that a rate order is unlawful in the absence of such costs.

We contend that the total effect of this rate order cannot be said to be unjust and unreasonable. We further contend that those seeking to upset the rate order have failed to carry "the heavy burden of making a convincing showing that it is . . . unjust and unreasonable in its consequences." [*Federal Power Com. v. Hope Natural Gas Co.*, 320 U.S. 591, 602 (1944)] This Court has long held that on judicial review appellate courts could not upset a rate order unless confiscation is clearly shown. [*Los Angeles G. & E. Co. v. Railroad Commission*, 289 U.S. 287 (1933); *Lindheimer v. Illinois Bell*, 292 U.S. 151 (1934)].

There is no convincing evidence here that the rate order is unjust and unreasonable in its consequences. Quite the contrary is true. The costing techniques adopted by the Commission were generous to the producers because it used two cost studies as yardsticks for pricing gas even though these yardsticks exceeded the actual costs of most of the gas produced in the area.

The Commission used as yardsticks the estimated cost of exploring for, developing, producing and selling (a) new gas-well gas of pipeline quality and of (b) flowing gas-well gas of pipeline quality. The record establishes that

the resulting rates actually exceed the cost of gas by a substantial amount for at least three reasons:

1. the type of cost studies used by the Commission as yardsticks include items of expense in excess of the actual cost of the gas subject to Commission regulation;

2. the Commission used cost studies for gas-well gas as its yardstick, and this type of gas has a cost higher than all other types of gas and substantially higher than 66 percent of the gas subject to the rate order; and

3. the yardstick cost included a rate of return to compensate for the risk of not finding pipeline quality gas.

A. THE TYPE OF COST STUDIES USED BY THE COMMISSION AS YARDSTICKS INCLUDE ITEMS OF EXPENSE IN ADDITION TO THE ACTUAL COST OF THE GAS SUBJECT TO COMMISSION REGULATION

The "costs" used as a yardstick by the Commission refers to costs determined by cost of service studies. This type of study, which was developed by the Commission in setting rates of gas, electric and pipeline companies, when applied to producers results in the inclusion of items in excess of the actual cost of the gas being sold.

With respect to exploration costs the Commission pointed out that:

> ". . . the price includes a 4.08 cents allowance for exploration and development expense even though such gas was largely found as a by-product of the search for oil. . . .
>
> "We do not mean to suggest that the E&D allowance and the profit which we have provided for flowing gas is not fully justified, but we believe it is relevant to point out that these two items, which account for 9.0 cents of the 14.5 cents price for flowing gas, are based in part on justifications other than cost, and provide ample allowance for the risk that low-quality gas in the area may not command the full area price." (Opinion No. 468A, R. Vol. XI, 1112d-1113d)

The court below agreed:

> "We agree with the Commission that the expense items included in an individual cost-of-service are not the measure of a confiscatory rate. A producer has no constitutional right to be reimbursed for dry-hole expenses. Also it has no obligation to remain in business by replenishing the supplies of gas which form the basis of present obligations. Inability to continue exploration and development is not confiscation. We conclude that the impact of the Permian rates on the high cost producers does not destroy the area rate method." *Skelly Oil Company v. Federal Power Commission,* 375 F.2d 6, 29 (10th Cir. 1967)

Thus, the court below found that a producer—on an individual cost of service basis—need not be reimbursed for all of his expenses, such as dry hole expenses. In such circumstances he would still not suffer confiscation. Similarly, on a group or composite basis, the exclusion of these same expenses would not result in confiscation.

Yet the Commission reimbursed the producers for *all* their expenditures—including dry hole expenses. Therefore, not only has confiscation *not* been shown, but items of expense in excess of a confiscatory rate have been allowed. It follows that the rate order is substantially above the confiscation level and it is for this reason not subject to attack. [*Los Angeles G & E Co. v. Railroad Commission,* 289 U.S. 287 (1933); *Lindheimer v. Illinois Bell,* 292 U.S. 151 (1934).[10]]

There are further reasons why the price chosen was in excess of that required on a Constitutional basis. The yard-

10. It is not our position that the Commission should not have included such expenses in the yardstick costs used to set rates. Such expenses are necessarily incurred in the finding and production of gas. However, according to the court below, the Constitution does not require reimbursement of these expenses for a valid rate order.

stick cost of service includes items to cover all exploration costs to find reserves to meet future demands. Although the interstate gas consumer is thus required to pay for this inventory of reserves, the producer is not required to sell the gas discovered into interstate commerce.

The cost of flowing gas-well gas employed by the Commission as a yardstick in setting ceiling rates for all flowing gas of pipeline quality was composed, exclusive of return on production investment, of the following items:

Production operating expense	1.75¢/Mcf
Depreciation, depletion and amortization	2.42
Exploration and development	4.08[11]
Regulatory expense	.14
	8.39¢/Mcf[12]

The exploration cost estimate included in the above yardstick cost was the national average expenditure for exploration in the year 1960 and was composed of the following: (a) dry-hole expense, (b) geological and geophysical expenses, (c) lease rentals, (d) cancelled and surrendered lease expenses and (e) all other costs expended on nonproductive property in the efforts to find gas. (R. Vol. X, 634d) Those expenditures resulted in the finding of reserves far in excess of the volumes produced. The average reserve additions in the years 1960 through 1963 were 138 percent of production.[13] Thus the full cost to producers of not only

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11. This includes .62 cents per Mcf return on investment in exploration facilities. (R. Vol. XI, 823d)

12. To this 8.39 cents per Mcf the Commission added 4.99 cents per Mcf as a return allowance (at 12 percent on production facilities) and state production taxes of 1.01 cents per Mcf bringing the total yardstick cost for old gas-well gas to 14.39 cents per Mcf. (R. Vol. X, 634d-639d)

13. The ratio of findings to production varied in each of these years. 1960 was 122%; 1961, 155%; 1962, 180%; 1963, 122%. The Commission found 1962 to be atypical and brought the 1962 figure down to the 1961 level making the four year average 138%. (R. Vol. X, 582d-583d)

obtaining new reserves to replace gas produced but to find 38 percent more for sale in the future was covered by the yardstick cost.

The cost of new reserves to replace production can thus be roughly estimated to be 2.96 cents per Mcf of the total exploration estimate of 4.08 cents per Mcf. The remaining 1.12 cents per Mcf was therefore provided for additional reserves which the producers can sell to anyone they wish, including the non-jurisdictional intra-state market.

The yardstick cost of new gas-well gas provided for total exploration costs of 4.12 cents per Mcf (3.01 cents per Mcf for replacement of reserves produced plus 1.11 cents per Mcf to acquire additional reserves for future sale to meet increasing demand). (R. Vol. X, 578d)

Both yardstick costs, therefore, included increments in excess of the cost of replacing gas produced. These increments do not in any way represent the cost of the gas being offered for sale. They are included in the yardstick cost to provide producers with funds to obtain gas for future sales. They are properly included for that purpose, but they are not part of the cost of the gas subject to the rate order.

All of the cost-of-service studies, with the exception of those for new gas-well gas, followed the format of that developed by the Commission and which was before this Court in *Second Phillips*.[14] The only significant difference is that in *Second Phillips* the studies reflected the costs of Phillips alone, whereas the material in the instant case was derived from a questionnaire which included the cost of the producers of over 70 percent of the gas in the Permian Basin. (R. Vol. IX, 309d)

A brief discussion of the cost of service in *Second Phillips* helps to point out the distinction between the

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14. Wisconsin v. Federal Power Commission, 373 U.S. 294 (1963).

cost of service and the cost of gas as a commodity. As the Court will recall from its decision in *Second Phillips*, the year 1954 was picked as the test year for the cost of service studies employed by the Commission in that case. Those studies were discussed in the majority opinion and discussed in detail by Mr. Justice Clark in his dissent.

Mr. Justice Clark was quite critical of the inclusion of certain exploration expenses in the cost of service. (*Second Phillips, supra* at 317, *et seq.*) On the facts of the case, he was more than justified in his criticism because the cost of service constructed by the Commission showed that Phillips' "costs" of engaging in the exploration, development, and production of gas in 1954 exceeded its revenues in that year by $8,900,000. *Second Phillips, supra* at 319. It was quite evident that this cost of service was substantially in excess of the actual cost to Phillips of the commodity being sold in 1954.

Most certainly Phillips, then entirely unregulated,[15] was not voluntarily selling its gas at less than its actual cost. It was there quite clear that "cost" determined on the cost of service basis far exceeded the price which was sufficient to elicit the then flowing supplies of gas from Phillips.

B. THE COMMISSION USED COST STUDIES FOR GAS-WELL GAS AS ITS YARDSTICK AND THIS TYPE OF GAS HAS A COST HIGHER THAN ALL OTHER TYPES OF GAS AND SUBSTANTIALLY HIGHER THAN 66 PERCENT OF THE GAS SUBJECT TO THE RATE ORDER

As earlier noted, the Commission used two cost studies as yardsticks. It used the estimated cost of exploring for, developing, producing and selling (a) new gas-well gas of pipeline quality and of (b) flowing gas-well gas of pipeline quality. Not only were these yardstick costs of 16.43 cents per Mcf and 14.39 cents per Mcf, respectively, higher than

15. Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672 (1954) was decided on June 7, 1954.

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the cost of service of the same type of gas of average quality,[16] but they were higher than the cost studies placed in evidence by the Staff as shown in the table at page 8, *supra.*

Over 66 percent of the gas produced in the Permian Basin is casinghead gas—that is gas produced from oil wells. (R. Vol. IX, 138d) As shown in the table at page 8, *supra,* the Commission Staff's cost study for this type of gas was 9.0¢ per Mcf. Nevertheless, under the Commission's decision, casinghead gas of pipeline quality could be priced at 14.5¢ per Mcf. The Commission was quite aware of this as it said:

> "While the cost of residue gas cannot be found with the precision requisite to serve as a basis for fixing ceiling prices, the evidence in the record makes clear that with respect to casinghead gas and residue gas derived therefrom (which together make up by far the largest share of the Permian gas subject to quality adjustments) the costs are substantially below the 14.5 cents per Mcf ceiling price. For one thing the price includes a 4.08 cents allowance for exploration and development expense even though such gas was largely found as a by-product of the search for oil. For another, there would be no reason to allow producers a 12 percent rate of return on their investment for processing residue gas since the investment in processing plants and equipment is subject to few of the special risks incurred by those who explore for and develop reserves of gas. (Opinion No. 468A, R. Vol. XI, 1112d-1113d)

Thus, it is apparent that two-thirds of the gas in Permian will receive a price substantially higher than the cost found by the Staff for such gas of average quality.

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16. As is discussed in the following section, the Commission used a 12 percent rate of return to compensate for the risk of not finding pipeline quality gas; whereas the studies in the record here referred to employed a 9½ percent rate of return thereby determining the cost of average quality gas.

C. THE YARDSTICK COST INCLUDED A 12 PERCENT RATE OF RETURN TO COMPENSATE FOR THE EXPLORATORY RISK AND FOR THE RISK OF NOT FINDING PIPELINE QUALITY GAS

In its yardstick cost estimates the Commission included a return allowance of 5.61 cents per Mcf on flowing gas (R. Vol. X, 634d; XI, 823d) and 5.56 cents on new gas (R. Vol. XI, 823d), based on a 12 percent rate, to cover the risk of exploration and the risk of not finding gas of pipeline quality. In this manner the Commission arrived at the estimated cost of exploring for, developing and producing new and flowing gas-well gas of *pipeline quality*. The estimated cost of *average quality* would have included a lower return.

The producers mistakenly argue that the cost estimated by the Commission for pipeline quality gas was for average quality gas. They then contend that this cost will not be covered because of quality reductions.

The Commission specifically held that a 12 percent rate of return would compensate the producers for the risk of not finding pipeline quality gas. The Commission neither expected nor anticipated that all gas would achieve the ceiling rates based upon a yardstick that included the 12 percent rate of return. With respect to new gas, it spelled out its approach as follows:

> "The principal uncertainty lies in finding gas in commercial quantities, and is emphasized by the record evidence that producers, while seemingly able to a degree to direct their searches for particular hydrocarbons, have no assurance that any hydrocarbon will be found. The risk of a dry hole—or noncommercial well—is one that has characterized the production activity since its inception.
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> • • •
>
> "There is another risk in the production operations which our allowance for rate of return in this proceeding must reflect—the risk of finding gas of less than

pipeline quality. The record reveals that the greater percentage of the gas in the Permian Basin does not fully meet the pipeline quality standards prescribed herein. . . . While we have provided upward adjustments for new gas-well gas with above average Btu content, nevertheless there remains the risk that any gas found can be sold only at an adjusted ceiling price which involves a substantial discount from the ceiling prices for gas of pipeline quality prescribed herein. Such risk is a special factor that must be considered in establishing the rate of return for the Permian Basin." (R. Vol. X, 601d-602d)

A similar approach was taken on flowing gas:

"In evaluating the risk factor for flowing gas we must therefore consider that there was by no means the same degree of risk knowingly undertaken in finding such gas as in the case of new gas-well gas. On the other hand, much of the flowing gas in the Permian Basin is below pipeline quality and thus will not command the ceiling price prescribed herein and this problem of low quality is more pronounced in flowing gas than in new gas-well gas.

"In our judgment these two factors of lesser and greater risk considered together with the other considerations in our previous discussion of rate return, which apply equally to flowing gas, persuade us that a 12 percent return is appropriate." (R. Vol. X, 633d)

In response to the producers' contention that quality adjustments would prevent them from achieving the so-called "revenue requirement", the Commission, on rehearing, stated:

"A major argument presented in the several producer applications for rehearing is that, because of the quality adjustments (presumably even as we are modifying them herein), the Commission has not fixed area rates at a level high enough to produce overall revenues

> which would in the aggregate match producer 'costs'. The argument fails to take account of the fact that the cost of gas-well gas that served as a yardstick for establishing the area rate includes a twelve percent rate of return (amounting to about 5 cents per Mcf) which the Commission expressly indicated was set at this figure in part (and in the case of flowing gas, where the problem of low-quality gas is more pronounced, in large part) in order to compensate for the risk of finding gas of less than pipeline quality." (R. Vol. XI, 1112d)

Commissioner Black made this point clear in his concurring opinion in supporting the Commission's decision in allowing a rate of return higher than heretofore allowed by the Commission in any proceeding:

> "Perhaps the most important single reason for a liberal rate of return allowance in the Permian Basin is that the greater part of Permian gas is substantially below pipeline quality. The Commission has provided for downward price adjustments to reflect these quality differentials with the result that much of the gas sold will not command the ceiling prices we have established. The very strong likelihood that the producers will continue to find large amounts of substandard gas is characterized by the main opinion as a risk factor, and I agree that it is appropriate to reflect this special risk in rate of return, which may well be sufficient to justify a return allowance of 12%." (Footnote omitted) (R. Vol. X, 771d-772d)

From the foregoing it is clear that the Commission found that the producers revenue requirements were significantly less than the yardstick costs used to set rates. Arguments alleging that the yardstick costs constituted the Commission's finding of revenue requirements and that those requirements were not met because of quality deductions are based on an obvious misreading of the Commission's decision.

III

Not Only Is the Total Effect of the Rate Order Just and Reasonable but the End Result Can Be Determined With Sufficient Precision to Demonstrate That It Is Just and Reasonable Also

Failing to perceive that the yardstick used by the Commission greatly overstated producer costs and that as a consequence the method employed in setting the rates assured that the result would be just to producers, the Court below, in the absence of any showing of confiscation, held the Commission rate order unlawful because it did not in precise, absolute terms demonstrate that the rates adjusted for quality discounts would cover all producer costs.

However, the Commission was not required to fix a precise revenue requirement or revenue level. Last term this Court in *Chicago and N.W.R. Co. v. A.T. and S.F.R. Co.*, ... U.S. ....., 18 L.ed2d 803, 817-818 (1967) stated:

> ". . . this Court has never suggested that ultimate findings of revenue need in terms of absolute dollar amount were required. . . . We decline now to impose upon the Commission a rigid mechanical requirement that is without foundation in precedent, practice, or policy."

This statement was made in response to contentions by certain railroads that the Interstate Commerce Commission was required to determine the revenue needs of various carrier groups in precise dollar amount. That Commission had declined to do this and the Court held:

> "We believe, however, that in the case's present posture these criticisms are largely misdirected." [*Chicago and N.W.R. Co. v. A.T. and S.F.R. Co., supra* at 816]

Thus, even though the Commission here was not required to do so, we submit that it did find the effect of quality dis-

counts with sufficient precision to establish that the end result of the rate order was just and reasonable. Concerning the impact of the quality adjustments, the Commission found:

> "With the changes we have here made with respect to quality standards, the average adjustments for gas-well gas will range from 0.7 cents to 1.5 cents, reduced by the additional revenue for plant liquids and the effect of the Btu adjustment." (R. Vol. XI, 1115d)

The Commission then went on to hold:

> "While it is true that neither the amount of the downward quality adjustments or the offsetting sources of additional revenue can be determined precisely, we are convinced that the record fully justifies the Commission's judgment that *the ceiling prices we have fixed 'provide a fair relationship between the aggregate price the consumer pays and the aggregate costs that the producers incur' in the Permian Basin.*" (Emphasis added) (R. Vol. XI, 1115d-1116d)

Commissioner O'Connor stated in his Concurring and Dissenting Opinion that:

> "The record does establish that the weighted average revenues received for all gas-well gas flowing in 1960 was 13.05¢. Applying an appropriate upward adjustment for quality deficiencies a price in the range of 14.0¢ and 14.5¢ is established. It is noted that this is a different standard for determining a price for old gas-well gas than for new. *Nevertheless, it is an appropriate standard for determining a regulatory rate reflecting the price at which a majority of producers are able and willing to sell gas for a period encompassing several years during which costs were apparently being recovered.*" (Footnote omitted—Emphasis added) (R. Vol. X, 751d-752d)

The same record evidence used by Commissioner O'Connor shows that the weighted average revenues received for *all* gas flowing in 1960 (including gas-well gas) was 12.72 cents per Mcf. (R. Vol. VII, 538e)

It is interesting to note that if the maximum downward adjustment claimed by Shell Oil Company,[17] 1.78 cents per Mcf, is deducted from the "base area rate" of 14.5 cents per Mcf the lowest "applicable area rate" for all flowing gas, *without* giving effect to any upward Btu adjustment, is 12.72 cents which is identical to the weighted average revenue for *all flowing gas* in 1960 shown above.[18]

As part of the Commission's order the producers were required to file statements showing the effect of adjustments in ceiling rates due to increases for high Btu content and

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17. Shell argued before the court below that on its analysis of the evidence the total adjustments for pressure, sulphur, water content and carbon dioxide "is in the range of 1.47 and 1.78 cents per Mcf for all gas flowing in 1960." (Shell Supplemental Brief before the court below, p. 14). However, Shell completely ignored the net upward Btu quality adjustment which results from the Commission's decision. For gas flowing in 1960 this upward adjustment amounts to 0.44 cents per Mcf. This has the net effect of reducing Shell's estimates to approximately 1.0 to 1.3 cents per Mcf. Reductions of this magnitude would indicate that the average applicable area rate for flowing gas based on 1960 volumes would range from 13.2 to 13.5 cents using Shell's analysis of the evidence corrected to properly reflect upward Btu adjustments.

18. It must also be pointed out that while not considered in the foregoing analysis, the Commission in its Decision on Rehearing (R. Vol. XI, 1112d-1115d) did point out that other factors exist which when considered show that substantial revenues are being received by the producers in addition to the rate established by the Commission. Specifically, the Commission referred to the rather substantial credits from gas liquids the producers receive from the pipeline companies in processing gas-well gas, together with additional revenues for liquids received by the producers under the so-called Spraberry Contracts. An estimate of the magnitude of the liquid credits returned to the producers was made by El Paso Natural Gas Company and referred to by the Commission in its Decision on Rehearing. (R. Vol. XI, 1114d) El Paso's estimate ranged from .6 cents to .8 cents per Mcf.

reductions for low quality gas. These statements were filed following the issuance of the Commission's order.

On January 6, 1967, the Commission issued its "Order Accepting Quality Adjustments" in which it found:

> "The impact of these quality adjustments, inclusive of Btu adjustments, for old gas-well gas and old residue gas deliveries in 1960 is 0.78¢ and 0.86¢ per Mcf, respectively." (Order of January 6, 1967, p. 2, as adjusted by Errata Notice of June 9, 1967)

Since the precise impact of the rate order is now known, it is apparent that the Commission in its decision overstated the effect of quality reductions. Therefore, the total effect of its rate order was more favorable to the producers than anticipated when it was issued.

IV

The Commission, on the Basis of the Evidence Could Not Authorize the Producers to Exceed Their Contract Price Limitations, nor Could It, as Urged, Raise the Otherwise Just and Reasonable Rate to Adjust for Low Contract Prices.

The producers, in furtherance of their argument that the Commission failed to permit them to recover their revenue requirements, argue that they will be precluded from doing so, to a considerable degree, because the Commission did not raise their low contract prices to the ceiling rates established by the Commission. This argument of the producers misconceives the theory of setting rates as a commodity rather than on the basis of producers' individual costs. Once the commodity price is established, the producer is free to seek that price.

However, under the rule of *Sierra*[19] and *Mobile*,[20] the Commission has no power to increase contract rates above those previously agreed to by producers, without a finding that such contract rates are so low as to adversely affect the public interest.

> "In such circumstances the sole concern of the Commission would seem to be whether the rate is so low as to adversely affect the public interest—as where it might impair the financial ability of the public utility to continue its service, cast upon other consumers an excessive burden, or be unduly discriminatory." [*Federal Power Com. v. Sierra Pacific Power Co.*, 350 U.S. 348, 355 (1955)]

The evidence here does not support the type of finding required by *Sierra*.

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19. Federal Power Com. v. Sierra Pacific Power Co., 350 U.S. 348 (1956).

20. United Gas Pipeline Co. v. Mobile Gas Service Corp., 350 U.S. 332 (1956).

Furthermore, those producers with low contract rates have the opportunity of seeking relief under the savings clause provided by the Commission in its rate order. Such producers are free to present to the Commission the evidence necessary for the Commission to lawfully raise their contract prices, and the nature of such evidence is quite clearly spelled out in the above quotation from *Sierra*.

V

The Commission Properly Concluded That the Inclusion of Gathering and Processing Costs Is Not Justified.

Several producers claim that the Commission erroneously failed to include in its cost computations the cost of gathering and processing residue gas. They claim that residue gas should be priced at a higher price than gas-well gas. The Commission, it should be recalled, set the price for residue gas at the same price as gas-well gas. In doing so it established a policy decision for future application which was supported by the evidence in this case.

Most of the residue gas in the Permian Basin area is derived from processing casinghead gas (the gas produced in association with oil). Some three or four percent is derived from gas-well gas. The gas is gathered and processed in order to strip the valuable liquid hydrocarbons from it. These liquids are then sold. The latter sales are not subject to the Commission's jurisdiction and the substantial profits derived from these sales are not subject to the Commission's scrutiny. (R. Vol. IX, 112d)

The Commission with regard to the claim that residue gas should receive a premium price over gas-well gas stated:

> "Hunt urges that residue gas must be priced higher than gas-well gas so that a processor selling residue gas can cover his processing costs plus a return on his investment in addition to the price of the gas-well gas he purchases. This reasoning ignores the fact that saleable liquid hydrocarbons are derived from the gas that is processed. The principal purpose of such processing is the removal of these liquids so that revenue may be realized from them. There is every reason to believe that the value of the liquids will be sufficient to justify gasoline plant processing of new gas-well gas. If not, there is no apparent economic reason to encourage the processing at gasoline plants.

"We therefore reject the argument that the price of residue gas derived from gas-well gas should exceed that of gas-well gas. For the future, if processors of gas-well gas cannot buy gas-well gas at a price which enables them to make a profit on their operations at the ceiling prices we prescribe, we assume that such gas will not be processed by the producers." (R. Vol. X, 623d-624d)

However, the Commission did not arbitrarily reject consideration of any real injury its prospective policy decision would cause. It left the door open for appropriate relief if the circumstances required by allowing a processor in an inequitable situation to apply for special relief:

"As to presently existing contracts by processors for the purchase of gas-well gas, if proper price relationships cannot be negotiated relief may be afforded in a proper case under the special relief provisions set forth later in this opinion. There should be very few of such cases, in view of the extremely small percentage of residue gas derived from gas-well gas." (R. Vol. X, 624d)

The Commission's decision is eminently fair especially so with respect to residue gas derived from casinghead gas and well within its discretionary powers. The Commission noted:

". . . [T]he evidence demonstrates that the cost of residue gas is lower than the cost of flowing gas-well gas." (R. Vol. XI, 1116d)

Thus, when it prices this lower cost residue gas on the basis of the higher yardstick cost of flowing gas-well gas it gives the producers a substantial advantage. The record showed that the cost estimates of casinghead gas were substantially below gas-well gas. The Examiner, in his decision, valued casinghead gas at only 75 percent of the value of

flowing gas-well gas. (R. Vol. IX, 231d) The Commission Staff estimated the cost of casinghead gas at 9 cents per Mcf and residue gas at 11.05 cents per Mcf, as we earlier noted, *supra,* at page 8. Even the producers' estimates showed the price of casinghead gas to be substantially below that of flowing gas-well gas.[21]

21. Producer witness Keene estimated the cost of casinghead gas at 4.1 cents per Mcf below his estimated cost of flowing gas-well gas. (R. Vol. VIII, 846e-850e)

VI

Refunds Must Be on an Individual Rate Schedule Basis

Once having determined the appropriate area rate—as the Commission did in this proceeding—it is then necessary to apply this rate to each of the rate schedules in the area proceeding. This is true whether the rate schedules are under scrutiny because of a rate increase placed into effect subject to refund by the producer under Section 4 (15 U.S.C. § 717c) of the Natural Gas Act or because the rate schedule is being questioned under the specific investigatory power of the Commission under Section 5 (15 U.S.C. § 717d). Those being reviewed under Section 5 would only involve a prospective change in the appropriate rate; however, those placed into effect subject to refund under Section 4 would involve a retroactive application of a just and reasonable rate.

Logic would seem to require the refund of all amounts collected under each rate schedule subject to refund in excess of the just and reasonable rate. Not only does logic require this interpretation, but the Natural Gas Act does as well. Section 4(e) of the Natural Gas Act gives the Commission power

> "upon completion of the hearing and decision, to order such natural gas company to refund, with interest, the portion of such increased rates or charges by its decision found not justified." (15 U.S.C. § 717c)

The meaning of this provision can only be that all amounts collected by the producer in excess of the applicable just and reasonable rate are "not justified" and must be refunded.

Any other result would create obvious inequities. The Commission noted this as follows:

> "Several fundamental objections preclude adoption of the examiner's proposed method of computing re-

funds. We think it would result in inequities among wholesale customers as well as among individual producers. If one wholesale customer has been overcharged it is of little comfort to him to know that another customer has received a bargain. Conversely, if one producer has collected excessive amounts, he should not be relieved of his responsibility to return the excess by reason of the fact that some other producer collected too little. Furthermore, the administrative difficulties involved in attempting for each year, and each category of sales, to equate industry revenues with industry expenditures, and to allocate the excess revenues among the purchasers, seem almost insurmountable." (Opinion No. 468, R. Vol. X, 673d)

The decision of the court below would allow the producers to balance revenues against "revenue requirements" on a group basis to determine whether any refunds are required. This view is plainly at odds with the philosophy of this Court expressed in *F.P.C. v. Tennessee Gas Transmission Co.*, 371 U.S. 145, 153 (1962) that:

> ". . . losses in the first instance do not justify its illegal gain in the latter. . . . The company . . . must, under the theory of the Act, shoulder the hazards incident to its action including not only the refund of any illegal gain but also its losses where its filed rate is found to be inadequate."

Furthermore, such an interpretation would, in effect, circumvent the holding of this Court in *Federal Power Com. v. Sierra Pacific Power Co.*, 350 U.S. 348 (1956), by allowing the producers to recover more than their contract rates in some instances.

The fundamental fact is that the interpretation adopted by the court below would allow producers to retain amounts collected in excess of the just and reasonable rate.

VII

The Commission's Savings Clause Is Adequate, Fair, and Administratively Feasible

The Commission in its opinion provided a Constitutional safety valve by alloving producers to petition the Commission for special relief from the area rate when their individual circumstances warrant. The court below rejected this savings clause as inadequate because it failed to specify precisely the special circumstances which would serve as a basis for exemption from the area rate. The court went on to suggest that a producer claiming a special exemption should have a stay of the general rate order until its claim for exemption is decided.

The conditions the court below would impose are too restrictive. There is no need at this time to specify each and every circumstance which gives rise to special exemption. Since each petition to the Commission for relief will involve different issues germane to the petitioner, it will be necessary for the issues of each petition to be delineated by the petitioner. Any petitioner claiming that he is entitled to special relief bears the burden of showing his entitlement to such relief. The savings clause is a general guideline which must be broad in its scope and terms to cover the multitude of special circumstances which may serve as a basis for exceptions to the area rate. If the Commission had been more specific in the savings clause, the producers would be deriding it because of its restrictive nature and citing numerous situations supporting a basis for exceptions not covered. Accordingly any other form of savings clause would be completely unworkable. Each petition must be determined on its own merits.

Furthermore, the suggestion that the area rate be stayed pending the determination of a claim for exemption from

the rate, if adopted, would create administrative havoc. If each producer were allowed to make a company cost of service presentation before the area rate could go into effect, this Court's direction to the Commission to move forward with procedures designed to protect consumers against excessive rates would be thwarted. [*Atlantic Ref. Co. v. Pub. Serv. Com. of New York*, 360 U.S. 378 (1959)]. The Commission's calendar would again be deluged with a multitude of petitions requiring extensive and costly hearings.

The Commission has provided through the savings clause a procedure for assuring fair treatment to individual producers who make a showing indicating entitlement to special relief and insuring that there will be no confiscation.

VIII

The Commission's Moratorium on Rate Increases Is Required

The court below sustained the Commission's authority to prescribe a moratorium because it is a practical necessity. For, if after several years of lengthy and costly litigation which results in findings of a just and reasonable rate the result could be overturned by the simple expedient of filing a rate increase under Section 4 (15 U.S.C. § 717c), all the effort put into the case would produce nothing because under the provisions of Section 4, the Commission would have the power to suspend the rate for only five months. It commented on this problem in its opinion as follows:

> "Without the limited moratorium on rate filings prescribed by our order herein this mammoth proceeding would fix prices for only a 5-month period and the producers could then overturn the Commission's order by a series of new filings to reinstate their pre-existing rates." (R. Vol. X, 663d)

The court below, relying on *Callery*,[22] stated:

> "In Callery the Court held that there was ample power under § 7(e) to impose a moratorium. We believe that there is also ample power under §§ 5(a) and 16. The reasonableness of the exercise of the power is established by the need for price stability, the Commission's expressed willingness to reopen the proceedings to consider the propriety of changes, and the expiration date which is only about a year off." (R. Vol. XII, 43-44)

Lengthy area rate proceedings should result in stability of prices for a reasonable time. If it is only imposed for a reasonable time, its use is not only appropriate, but it is

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22. United Gas Improvement Co. v. Callery Properties, Inc., 382 U.S. 223 (1965).

absolutely essential to the proper administration of the area method of regulation.

In this proceeding there was substantial evidence to support the length of time adopted by the Commission. It noted in establishing the moratorium period that the evidence showed that since 1960 "costs have remained remarkably steady" and "are likely to remain steady during the moratorium period." (R. Vol. X, 661d-662d)

Therefore, the moratorium is appropriate.

IX

The Just and Reasonable Area Rate Must Be Adopted as the In-Line Rate for the Area

On the same day that the Commission issued Opinion 468, it issued an order applying as the in-line price to certain initial Section 7 applications that had been earlier consolidated with the area rate case the just and reasonable area rate it had just determined. (R. Vol. XI, 827d, *et. seq.*) Texaco Inc. objected to this approach and filed an application for rehearing. (R. Vol. XI, 1027d)

The court below in its opinion on rehearing refused to decide whether the area rate established after extensive hearings automatically becomes the in-line rate in a Natural Gas Act Section 7 (15 U.S.C. § 717f) proceeding because it rejected the area rate. We contend that a decision on this issue is essential to the orderly administration of producer regulation under the Natural Gas Act.

If the Commission is unable to apply the area rate determined in proceedings under Sections 4 (15 U.S.C. § 717c) and 5 (15 U.S.C. § 717d) of the Natural Gas Act as the rate for new sales authorized under Section 7, the painstaking and time-consuming effort involved in area ratemaking will have little prospective application to new supplies sold in interstate commerce. By not applying the area rate as the in-line rate, Section 7 proceedings would become a sieve through which excessive prices will be certificated for new gas until another area rate proceeding is completed.

Common sense itself dictates that any rate in excess of the area rate is "suspect" and therefore an invalid basis for an in-line determination. The only nonsuspect price is the area rate and it must therefore be the in-line price. Accordingly, it is not only appropriate, but it is indeed imperative that the area rate determined in a Section 4 or

Section 5 proceeding be used as the in-line rate for a reasonable period of time after the conclusion of the area rate case if the consumer is to be afforded needed protection under the Natural Gas Act. [*Atlantic Ref. Co. v. Pub. Serv. Com. of New York*, 360 U.S. 378 (1959)]

X

The Commission May Lawfully Set Rates on an Area Basis

The court below after exhaustively analyzing all the authorities, concluded:

> "We believe that neither constitutional nor statutory provisions prevent the use of [the area rate] method and that the Commission did not abuse its discretion in adopting it." [*Skelly Oil Co. v. FPC*, 375 Fed.2d 6, 22 (10th Cir. 1967)]

But some still argue that the Commission's area rate approach is unlawful. After searching for a method of regulating producer prices for six years the Commission concluded in 1960 that it was neither wise nor administratively feasible to regulate on an individual company cost of service basis and would thereafter follow an area approach in setting producer rates.

The lawfulness of the area approach was raised in *Wisconsin v. F.P.C.*, 373 U.S. 294 (1963), and this Court then said:

> "[T]o declare that a particular method of rate regulation is so sanctified as to make it highly unlikely that any other method could be sustained would be wholly out of keeping with this Court's consistent and clearly articulated approach to the question of the Commission's power to regulate rates. *It has repeatedly been stated that no single method need be followed by the Commission in considering the justness and reasonableness of rates, . . . More specifically, the Court has never held that the individual company cost-of-service method is a sine qua non of natural gas rate regulation.*" (Emphasis added) *Ibid* at 309.
>
> • • •
>
> "We recognize the unusual difficulties inherent in regulating the price of a commodity such as natural gas. *We respect the Commission's considered judgment, backed by sound and persuasive reasoning, that the*

individual company cost-of-service method is not a feasible or suitable one for regulating the rates of independent producers. We share the Commission's hopes that the area approach may prove to be the ultimate solution." (Emphasis added) *Ibid* at 310.

• • •

"The Court cannot resolve this dispute against the Commission and tell it that it has made an error of law—abused its discretion—in deciding how best to allocate its resources. The case might be different if the area approach has little or no chance of being sustained; . . ." *Ibid* at 313-314.

More recently, this Court reiterated its tacit approval of the general approach in *United Gas Improvement Company v. Callery Properties, Inc.*, 382 U.S. 223 (1965), when it approved the Commission's interim rate procedure under Section 7 of the Natural Gas Act pending the determination of just and reasonable rates under Sections 4 and 5 of the Act in area rate cases.

There is more than an adequate basis for the Court's attitude that area ratemaking is proper. Take, for example:

"The Constitution does not bind rate-making bodies to the service of any single formula or combination of formulas. Agencies to whom this legislative power has been delegated are free, within the ambit of their statutory authority, to make the pragmatic adjustments which may be called for by particular circumstances." [*FPC v. Natural Gas Pipeline Company*, 315 U.S. 575, 586 (1942)]

• • •

"We held in *Federal Power Commission v. Natural Gas Pipeline Co., supra*, that the Commission was not bound to the use of any single formula or combination

of formulae in determining rates." [*FPC v. Hope Natural Gas Company,* 320 U.S. 591, 602 (1944)]

• • •

"But it has never been thought that price-fixing, otherwise valid, was improper because it was on a class rather than an individual basis. Indeed, the decision in Munn v. Illinois, 94 U.S. 113, the pioneer case in this Court, involved a legislative schedule of maximum prices for a defined class of warehouses and was sustained on that basis." [*Bowles v. Willingham,* 321 U.S. 503, 518 (1944)]

• • •

"It is not necessary, for general revenue purposes, to establish for each item in each freight rate a fully developed rate case." [*King v. United States,* 344 U.S. 254, 275 (1952)]

Some producers continue to contend that the area rate approach is invalid because the high-cost producer is not compensated for the gas he is selling. This contention fails to understand that there is no need for a rate set on a group basis to return a profit to every member of the group, including those with unreasonable or excessively high costs.

To set a rate which would return a profit to every group member would require a rate high enough to compensate high-cost producers for their inefficiency and thereby provide an unnecessary windfall for the average and low-cost producers at the expense of the consumer.

Furthermore, the high-cost producer is not a victim of unconstitutional confiscation as some producers contend. The Commission indicated that under the "savings clause" procedure it will grant relief to the producer whose out-of-pocket expenses for a sale exceed the revenues from that sale. The Commission would allow the producer to abandon the sale, or take other appropriate action which best serves the public interest.

Some of the producers contend that they are entitled to individual findings on their particular costs. Such findings, however, are administratively impossible in an area rate proceeding and are not legally or constitutionally required. Last term this Court addressed itself to a similar problem arising under the Interstate Commerce Act. In sustaining the Interstate Commerce Commission's decision to take evidence and make findings on a group basis, the Court stated:

> "The pragmatic justifications for the Commission's group procedures are obvious. Even on a group basis, the Commission proceedings in this case required a voluminous record and were not completed until nearly 10 years after the complaints were filed. To demand individual evidence and findings for each of the 300 carriers in the Commission proceedings would so inflate the record and prolong administrative adjudication that the Commission's regulatory authority would be paralyzed.
>
> "Nor do considerations of fairness require disregard of administrative necessities. The premise of group proceedings, as the New England Divisions Case explicitly recognized, is that evidence pertaining to a group is typical of its individual members. 261, US, at 196-199, 67 L ed at 611, 612. See also Beaumont, S.L.&W.R.Co. v United States, 282 US 74, 82-83, 75 L ed 221, 228, 51 S Ct 1. It has always been accepted that an individual carrier may challenge this premise and, on proper showing, receive independent consideration if its individual situation is so atypical that its inclusion in group consideration would be inappropriate. It is the Commission's practice to accord independent treatment to an individual carrier when a proper request for special consideration is made."
>
> [*Chicago & N.W.R. Co. v. A. T. & S.F.R. Co.*, ... U.S. ....., 18 L.ed2d 803, 815 (1967)]

It is of particular interest to note this Court's reliance on the constitutional safety valve which allowed individual

carriers upon proper showing to receive individual consideration. The Commission itself has provided for the precise same treatment of atypical producers in its "savings clause."

CONCLUSION

The long awaited Commission method of producer regulation should be affirmed since it provides an administratively workable program for setting rates which protect both the producer and the consumer. The Commission's order has produced the effect it anticipated as is apparent from the recent extensive drilling activity in the Permian Basin area. Recent trade journals report at length on the substantial reserves being found in the Deep Delaware Basin area of the Permian Basin and the ease of marketing of gas found to interstate pipelines.[23]

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23. "Lockridge poised to challenge gas giants," *The Oil and Gas Journal,* June 12, 1967, p. 54.

"Gulf hits huge Gomez gasser," *The Oil and Gas Journal,* May 8, 1967, p. 65.

"Deep Delaware Basin—Major New Gas Area," *Oil & Gas Discoveries,* April 1967, p. 4.

"Deep Hole Upsurge Continues Despite Rise in Drilling Costs," *Petroleum Engineer,* March 1967, p. 51.

"Delaware basin score is 55," *The Oil and Gas Journal,* March 6, 1967, p. 139.

"Gomez field, West Texas Delaware basin," *The Oil and Gas Journal,* February 27, 1967, p. 78.

"Going down," *Shell News,* January/February 1967, p. 4.

"Grey Ranch may fire Val Verde search," *The Oil and Gas Journal,* January 9, 1967, p. 51.

"New techniques cut drilling costs in the Delaware basin," *Journal of Petroleum Technology,* November 1966, p. 117.

"Market Potential of Deep Delaware Basin Gas Reserves," *Journal of Petroleum Technology,* October 1966, p. 1257.

"Delaware Basin Drilling—1966," *Journal of Petroleum Technology,* October 1966, p. 1267.

"Deep Wells Reach New High In 1965; Costs Decline Again," *Petroleum Engineer,* March 1966, p. 59.

Most of this drilling activity and these interstate sales have occurred after the Commission's *Permian* decision, and the producers have gone forward with these extensive activities with the knowledge that *Permian* price levels would be applied to the interstate sales. This is convincing proof of the practical effectiveness of the *Permian* decision.

Respectfully submitted,

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PETITIONER'S BRIEF

NOV 2 3 1967

OFFICE OF THE CLERK

Nos. 95, 96, 102, 105, 117, 181

In the Supreme Court of the United States

OCTOBER TERM, 1967

THE PERMIAN BASIN AREA RATE CASES

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE FEDERAL POWER COMMISSION

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In the Supreme Court of the United States

OCTOBER TERM, 1967

Nos. 90, 95, 98–102, 105, 117, 181

THE PERMIAN BASIN AREA RATE CASES [1]

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE FEDERAL POWER COMMISSION

OPINIONS BELOW

The opinion of the court of appeals (XII R. 15–61 [2]), as well as its opinion on rehearing (XII R. 87–89), are

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[1] *Continental Oil Co.* v. *Federal Power Commission; Superior Oil Co.* v. *Federal Power Commission; New Mexico* v. *Federal Power Commission; Sun Oil Co.* v. *Federal Power Commission; California* v. *Skelly Oil Co.; Hunt Oil Co.* v. *Federal Power Commission; Pacific Gas & Elec. Co.* v. *Skelly Oil Co.; Bass* v. *Federal Power Commission; Federal Power Commission* v. *Skelly Oil Co.; City of Los Angeles* v. *Skelly Oil Co.* Petitions for certiorari challenging various aspects of the Tenth Circuit's *Permian* decision have been filed, but not acted on, in No. 261 (*City and County of San Francisco* v. *Skelly Oil Co.*), No. 262 (*City of San Diego* v. *Skelly Oil Co.*), No. 266 (*Standard Oil Co.* v. *Federal Power Commission*) and No. 388 (*Mobil Oil Corp.* v. *Federal Power Commission*). This brief discusses the contentions made in those petitions.

[2] We employ the following system in citing to the 14-volume record in this Court: "R. 1–R. 1908"—Volumes I–V (testimony);

reported at 375 F. 2d 6. The opinions and orders of the Federal Power Commission (R. 516d–826d, 827d–838d, 37s, 1105d-1132d, and 1133d–1136d) are reported at 34 F.P.C. 159, 418, 424, 1068, and 1082. The opinion of the Commission's hearing examiner (R. 97d–364d) is reported at 34 F.P.C. 306.

JURISDICTION

The judgments of the court of appeals were entered on January 20, 1967 (XII R. 62–83). An order modifying the judgments was entered, after rehearing, on April 18, 1967. The petition for certiorari in No. 90 was filed on April 17, 1967. The petitions in Nos. 95, 98 and 99 were filed on April 18. The petition in No. 100 was filed on April 19 and a supplementary petition on May 4. The petition in No. 101 was filed on April 19. The petition in No. 102 was filed on April 19 and a supplementary petition on May 8. The petition in No. 105 was filed on April 20. On April 18, 1967, Mr. Justice White extended the time of the Federal Power Commission to file a petition for certiorari to June 19, 1967, and its petition (No. 117) was filed on May 1. Mr. Justice White, on April 17, granted the City of Los Angeles an extension of time until June 19, 1967, to file its petition, which was filed on May 20 (No. 181). All of the petitions were granted on June 12, 1967. (XII R. 89–90). The

"R. 1e–R. 1146e"—Volumes VI–VIII (exhibits); "R. 1d–R. 1157d"—Volumes IX–XI (pleadings, orders and opinions in the administrative proceeding); "XII R. 1–XII R. 90"—Volume XII (proceedings in the court of appeals and this Court); "R. 1s–R. 40s" (supplementary volume). This remaining volume is a table of contents for Volumes I–XI.

jurisdiction of this Court is invoked under 28 U.S.C. 1254(1) and Section 19(b) of the Natural Gas Act, 15 U.S.C. 717r(b).

STATUTES INVOLVED

The pertinent provisions of the Natural Gas Act, 52 Stat. 821, as amended, 15 U.S.C. 717–717w, are printed in the Appendix, *infra*, pp. 173–181.

QUESTIONS PRESENTED

The Federal Power Commission fixed, on an area basis, the maximum just and reasonable rates which could be charged by independent producers of natural gas in the Permian Basin. Numerous questions are presented in the various petitions for certiorari which have been consolidated in this Court. The principal questions may be outlined as follows:

1. Whether an area approach to the regulation of producers' rates is permissible and appropriate. Embraced in this broad question are the following subsidiary issues:

a. Whether the Constitution or the Natural Gas Act precludes such an approach.

b. Whether area regulation is appropriate to the needs and conditions of the gas-producing industry and its consuming public.

c. Whether the Commission was required to specify the circumstances in which a producer would be granted exceptions from area rates and must automatically stay the application of those rates whenever a producer seeks an exception.

d. Whether the Commission properly imposed a limited moratorium on filing rate increases above the

area ceiling and a permanent prohibition on filing any such increase if based upon certain indefinite escalation clauses.

2. Whether the area rates prescribed by the Commission for the Permian producers are just and reasonable. More particularly—

a. Whether the producers were entitled to an opportunity to be heard on the delineation of the relevant area in this proceeding.

b. Whether the Commission was justified in keying the area rates to costs rather than contract prices.

c. Whether it was permissible for the Commission to price new gas-well gas differently from flowing gas and to base the price of all flowing gas on the costs of old gas-well gas.

d. Whether the Commission's methods of costing, its allowance for return on investment, and its delineation of standards for determining when gas is of pipeline quality (and hence entitled to the full rate) were appropriate.

3. Whether the Commission was required to raise all existing contractual prices that are below the area rates established by it in this proceeding, or to forgive all or a portion of the producers' past excessive charges because some of their sales were below the ceilings which the area rates establish.

4. Whether the court of appeals, in staying the effectiveness of the rate reductions ordered by the Commission, erred in prescribing a 4½-percent interest rate, when a 7-percent rate had been prescribed by the Commission.

STATEMENT

The Federal Power Commission, acting under the Natural Gas Act, initiated this proceeding in 1960 to establish maximum just and reasonable rates for interstate sales by independent producers of natural gas in the Permian Basin of western Texas and southeastern New Mexico. This is one of the nation's principal oil and gas producing regions, accounting for about 11 percent of all of the natural gas that moves in interstate commerce. After extended administrative proceedings, the Commission, in 1965, issued its decision, prescribing area rates and rendering various incidental rulings and orders (*e.g.*, directing refunds). On judicial review, the Court of Appeals for the Tenth Circuit sustained in part and set aside in part the Commission's orders. Petitions for certiorari were filed both by producer interests, attacking the court of appeals' decision insofar as it sustained the Commission, and by the Commission and consumer interests, attacking the decision below insofar as it reversed the Commission. All of the petitions were granted, and the cases consolidated. We discuss all of the tendered issues in this brief, urging that the Commission's decision be sustained in its entirety.

1. THE HISTORY OF GAS PRODUCTION AND PRICES IN THE PERMIAN BASIN

The Permian Basin has long been celebrated for its production of crude oil—and hence of "oil-well" gas, a byproduct of crude oil—from hundreds of reservoirs and thousands of wells. Since World War II, Permian producers have also found and developed

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gas reservoirs, from which "non-associated", or "gas-well", gas is produced; that production has increased steadily. About two-thirds of the gas produced in the Permian Basin, however, is still oil-well gas; in contrast, oil-well gas represents only about one-third of the total gas production in the continental United States.

The first discoveries of the Permian oil fields date back to the 1920's (R. 289), but oil-well gas was largely wasted until 1946 when the area first secured a significant interstate market outlet through the certification of El Paso Natural Gas Company's original line to California.[3] *El Paso Natural Gas Co.*, 5 F.P.C. 115, 122–123. The bulk of El Paso's Permian Basin supply consisted of approximately 65,000 Mcf a day from Phillips Petroleum Company, 30,000 Mcf a day from Gulf Oil Corporation, 20,000 Mcf a day from Shell Oil Company, and 10,000 Mcf a day from Warren Petroleum Corporation (5 F.P.C. at 122). These supplies were purchased under long-term contracts, consistently with the industry's practice of committing most gas supplies under contracts of twenty years or

[3] Previously, the only "long distance" line in the area was El Paso's pipeline from the Jal area of Lea County, New Mexico, to El Paso, Texas; and it took rather small volumes. While some towns in the area used local gas, the larger ones received gas from the Texas Panhandle, because Permian Basin gas at the time was mostly "sour gas"—that is, it had a high sulphur content—and it was cheaper to transport sweet gas from the Panhandle than to purify the local sour gas. Carbon black plants in a few fields provided the only other market in the area. The gas that had no market was either flared (if produced with oil), or, in the case of gas wells, shut in, in the hope that a market might some day develop (R. 45, 433).

more (R. 233e–252e). El Paso originally contracted for the Phillips supply at an initial price of 3½ cents per Mcf, subject to escalation every five years, as well as to further, indefinite escalations if El Paso's resale rates increased at the California border. (The latter type of provision became known as the "spiral escalation clause.") The original Shell and Warren contracts provided an initial price of 3 cents per Mcf together with variants of the spiral escalation clause. The Gulf contract provided an initial price of 4 cents (for high pressure, sweet gas) subject to a limited spiral clause and a "favored nation" clause under which Gulf was guaranteed a price no lower than that of other producers in the area.

The very low prices in the original contracts were short-lived. During 1947, El Paso had purchased gas in the Permian Basin at an average cost of 2.8 cents per Mcf and charged an average price of 15.2 cents at the California border (R. 179e); by 1953 (the last year before the Natural Gas Act was held applicable to producer sales, see *infra*, p. 9), El Paso's average purchased-gas cost in the Permian Basin area had risen to 8.3 cents per Mcf (R. 179e).[4]

On May 1, 1953, the Commission certified the facilities of the second major buyer in the area, Permian Basin Pipeline Company (a wholly-owned subsidiary

[4] These average purchase costs combine a span of field prices. El Paso's contracting practice (before as well as after 1954) recognized a number of quality differentials. Thus, in 1953, El Paso's contracts for residue gas from plants ranged from 7.0 cents per Mcf for low pressure, sour, undehydrated gas to 10.0 cents per Mcf for high pressure, sweet, dehydrated gas. Similar differentials continue to be imposed contractually (R. 1859–1862, 1902, 1125e).

of Northern Natural Gas Company, since merged into the parent firm). *Permian Basin Pipeline Co.*, 12 F.P.C. 85. The backbone of Permian Pipeline's supply came from Phillips Petroleum Company under a basic contract signed February 8, 1952, which provided for deliveries of oil-well gas produced in the Spraberry Trend area [5] and, by subsequent amendment, for sales of gas-well gas from the Puckett Ellenberger Field, discovered only eight months prior to the certification of Permian Pipeline. Permian Pipeline also agreed to purchase gas from various producers in southeast Lea County, New Mexico, which is also in the Permian Basin area.

The contracts provided initial prices of 10 cents per Mcf of Spraberry gas (generally sweet, high pressure gas) at the tailgates of Phillip's plants; 15 cents (minus a 5-cent purification adjustment) per Mcf for Puckett Field dry gas; and 9.5 cents per Mcf for the Lea County gas. Among other escalation clauses, the contracts called for an increase of 1 cent per Mcf every five years. In 1957, prices rose by that amount.

During the Korean War, the Office of Price Stabilization proscribed the inflationary operation of indefinite pricing clauses. 17 Fed. Reg. 10292. These controls ended on March 12, 1953. 18 Fed. Reg. 1477.

[5] Here, too, gas had previously been wasted. In certificating Permian Pipeline, the Commission noted "that the Texas Railroad Commission has recently ordered the Spraberry Trend fields shut in because of persistent flaring of residue gas for which no market at present exists. The proposed Permian project will provide one means for disposition of large volumes of residue gas which have hitherto been wasted" (12 F.P.C. at 91–92).

Fifteen months later, on June 7, 1954, this Court upheld the Commission's jurisdiction over producer sales at wholesale in interstate commerce. *Phillips Petroleum Co.* v. *Wisconsin,* 347 U.S. 672. Nevertheless, after 1954, Permian Basin field prices continued their rise. One factor was the increase in El Paso's initial contracting levels—by 1958, its prices for oil-well gas ranged from 8.0 to 11.0 cents, depending on quality (R. 1125e). But indefinite escalation clauses exerted a still greater upward pressure. On three occasions—in 1957, 1958 and 1960—Phillips put into effect increased rates which, it alleged, were permitted by its spiral-escalation clause with El Paso. These rates were suspended by the Commission for five months (the maximum permissible suspension) under authority of Section 4 of the Natural Gas Act,[6] and their subsequent collection made subject to eventual refund should they be found unjust and unreasonable. On each occasion, a general field price rise in the Permian Basin area ensued, triggered by the favored-nation clauses in El Paso's other contracts (R. 1858–1859).

Rate-increase filings based on favored-nation clauses continued the upward trend. These filings were also suspended and their subsequent collection made subject to eventual refund (they constitute a major portion of the Section 4 proceedings consolidated in this proceeding, see R. 294e–319e). Each escalation

[6] FPC Docket No. G–11217, rates effective subject to refund March 11, 1957; FPC Docket No. G–14115, rates effective subject to refund June 1, 1958; FPC Docket Nos. G–18417 and G–18418, rates effective subject to refund January 1, 1960. All but the first of these dockets were consolidated in this proceeding.

of the general price level produced an upward thrust in El Paso's purchased-gas cost, resulting in a further increase in El Paso's resale rates which activated the spiral clause again. Rate cases accumulated before the Commission. By 1960, to be sure, El Paso had renegotiated most of its Permian Basin contracts to eliminate the various indefinite pricing clauses; but, in exchange, it had allowed yet another substantial price increase (R. 1860–1862). Spiral-escalation and favored-nation increases had raised El Paso's purchase price levels by 2 to 4 cents over the 8-to-11-cent range in effect in 1958; the renegotiation resulted in a further rise of 2 to 3 cents to the 13.5–17.0-cents range (see R. 121–122, 94e–112e, 115e). The few producers who did not renegotiate their contracts with El Paso took advantage of the renegotiation nevertheless—by filing for higher rates under their favored-nation clauses.[7]

In 1958, a new buyer, Transwestern Pipeline Company (then merely a promotional venture), began to negotiate contracts for Permian Basin gas at prices in the general range of 16–22 cents per Mcf. Transwestern was certificated on August 10, 1959. *Transwestern Pipeline Co.*, 22 F.P.C. 391. Under a subsequently repudiated doctrine of allowing the highest previously certificated price in any area as the "in line" price,[8] the Commission authorized Transwestern

[7] The Commission suspended the renegotiated rates as they were filed. Under the renegotiation, periodic escalations (up to 14.5–18.0 cents) were due on August 1, 1964, and these became effective after the statutory suspension period.

[8] The in-line price is the maximum initial price at which gas may be sold pending determination of maximum just and rea-

to purchase gas at initial prices of 16 and 18 cents. 22 F.P.C. at 398–400.[9] Transwestern commenced operations toward the end of 1960; El Paso's renegotiated prices also began to go into effect (subject to refund) that year. The average field price for gas of all qualities and "vintages" rose rapidly, and reached 14.0 cents per Mcf by the end of 1960 (R. 1026e). Additional renegotiated rates, suspended by the Commission, went into effect in early 1961 (R. 1079e, 1092e). By the end of 1960, more than 500 rates in excess of 14.5 cents per Mcf—including almost 200 rates in excess of 16.5 cents per Mcf—had been filed with the Commission (R. 320e–344e). These rate schedules represented more than half the gas then being sold in the Permian Basin area (R. 1099e–1107e).[10]

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sonable rates. *Atlantic Refining Co.* v. *Public Service Commission of New York*, 360 U.S. 378 ("*Catco*").

[9] This order was not appealed. A number of other producer-certificate orders issued the same day under the highest-price doctrine were all reversed upon appeal by consumer interests. *The California Co.*, 22 F.P.C. 252; *Sun Oil Co.*, 22 F.P.C. 351; *Sunray Mid-Continent Oil Co.*, 22 F.P.C. 361; *The Superior Oil Co.*, 22 F.P.C. 369; and *Texas Gas Transmission Corp.*, 22 F.P.C. 378, reversed, respectively, *sub nom. United Gas Improvement Co.* v. *Federal Power Commission*, 283 F. 2d 817 (C.A. 9), certiorari denied, 368 U.S. 823; 287 F. 2d 159 (C.A. 10); 290 F. 2d 147 (C.A. 5), certiorari denied, 366 U.S. 965; *sub nom. Public Service Commission of New York* v. *Federal Power Commission*, 287 F. 2d 146 (C.A.D.C.), certiorari denied, 365 U.S. 880, 882.

[10] El Paso remains the major interstate purchaser in the Permian Basin. In 1961, it purchased 73 percent of the Permian gas in interstate commerce; Northern accounted for 18 percent; and Transwestern, 9 percent. About 85 percent of this gas goes to California (R. 536d).

Such was the background of the Permian area proceeding, initiated at the end of 1960.

2. THE ADOPTION OF THE AREA APPROACH

Not a little of the responsibility for the continuous and steep escalation of Permian gas prices in this period may be laid to the vicissitudes of regulation. In 1954, as mentioned, this Court had held (contrary to the Commission's previous view) that the Commission's jurisdiction under the Natural Gas Act extended to sales of natural gas at the wellhead. Prior to that time, the Commission had long regulated the rates of electric utilities and natural gas pipeline companies on an individual company cost-of-service approach, and after 1954 it attempted to regulate the thousands of independent producers on the same basis.[11] A few early increased-rate filings were approved on this basis. In a number of cases, the producer's failure to submit cost-of-service evidence was deemed a sufficient basis for disallowing the increase,[12] but these proceedings had little consequence as the Commission soon developed a backlog that it found impossible to liquidate under the case-by-case approach. In the 1956–1959 period, a number of major producer cases were initiated by the Commission under Section 5(a) of the Gas Act. The first of these

[11] At first, the Commission sought to develop an overall approach to producer regulation through a rule-making proceeding (Docket No. R–142), but after hearing oral argument it abandoned that course in favor of the case-by-case approach. 13 F.P.C. 1524; 14 F.P.C. 1128.

[12] The Fifth and District of Columbia Circuits agreed with the Commission that evidence as to field prices, even when coupled with opinion testimony as to the need for an incentive

to be decided on the merits was the original *Phillips* case, which had been remanded by this Court in its landmark 1954 decision. On remand, the case had been tried under the traditional individual-company cost-of-service approach. Reviewing the results, the Commission concluded that the approach was inappropriate and unworkable as a method for determining just and reasonable producer rates. While approving a limited number of Phillips' increased-rate filings for past periods on that basis, it ruled that, for the future, rates for Phillips and other independent producers would be determined on an area basis. *Phillips Petroleum Co.*, 24 F.P.C. 537.

On the same day that the Commission rendered its decision—September 28, 1960—it also issued Statement of General Policy No. 61–1 (24 F.P.C. 818), which initiated the area rate approach on an interim basis by announcing guideline ceiling prices for various producing areas. One set of guidelines set forth the initial prices at which the Commission indicated it would certificate new sales of gas of pipeline quality in the absence of protest; a separate set of guidelines stated prices for pipeline-quality gas above which increased rate filings would be suspended. For the

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price to induce exploration and development, was not sufficient to show the justness and reasonableness of the rates. See, *e.g.*, *Bel Oil Corp.* v. *Federal Power Commission*, 255 F. 2d 548 (C.A. 5), certiorari denied, 358 U.S. 804; *Forest Oil Corp.* v. *Federal Power Commission*, 263 F. 2d 622 (C.A. 5); *Episcopal Theological Seminary* v. *Federal Power Commission*, 269 F. 2d 228 (C.A.D.C.), certiorari denied *sub nom. Pan American Petroleum Corp.* v. *Federal Power Commission*, 361 U.S. 895.

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Permian area,[13] these guidelines were 16 cents per Mcf and 11 cents, respectively. The present case looking to the establishment of just and reasonable Permian area rates was initiated on December 23, 1960 (R. 1d).

On review, the Commission's *Phillips* decision was affirmed by both the court of appeals and this Court (*Wisconsin* v. *Federal Power Commission,* 303 F. 2d 380 (C.A.D.C.), 373 U.S. 294). In rejecting the argument that the Commission had abused its discretion in terminating the Section 5(a) investigation of Phillips' rates in favor of an area approach, this Court said (373 U.S. at 310):

> * * * We respect the Commission's considered judgment, backed by sound and persuasive reasoning, that the individual company cost-of-service method is not a feasible or suitable one for regulating the rates of independent producers. We share the Commission's hopes that the area approach may prove to be the ultimate solution.

Other area proceedings were initiated after the Permian case and are in progress today: relating to the Southern Louisiana area (awaiting Commission decision after oral argument), the Hugoton-Anadarko area (final briefs to examiner filed July 31, 1967), and the Texas Gulf Coast area (final briefs to examiner filed July 31, 1967). More than seventy-five percent of all sales of natural gas subject to the Commission's

[13] The Permian area, as defined in the instant proceeding, is a consolidation of three of the original pricing areas—Texas Railroad Commission District No. 7-C, Texas Railroad Commission District No. 8, and New Mexico-Permian Basin.

jurisdiction are made in these four areas (R. 540d–541d). On February 28, 1967, the Commission initiated a fifth proceeding that will encompass an additional 14 percent. *Area Rate Proceeding (Other Southwest Areas)*, Docket Nos. AR67–1, *et al.*, 32 Fed. Reg. 3792, March 7, 1967.

3. THE COMMISSION'S PERMIAN DECISION

There were 384 parties before the Commission in the instant proceeding, including 336 gas producers who had been named as respondents and numerous representatives of consumer interests. Hearings, which began on October 11, 1961, and closed on September 10, 1963, produced a transcript of more than 30,000 pages. The examiner issued his decision on September 17, 1964 (R. 97d–364d). The Commission, which heard oral argument for three days, issued an exhaustive opinion (No. 468) on August 5, 1965 (R. 516d–826d).

A. THE AREA APPROACH

In its opinion, the Commission held that it had both statutory and constitutional authority to determine independent producers' rates on an area basis—that is, to fix a uniform rate rather than a rate for each producer based on his individual costs—and that the area approach should be adopted because "it is well adapted to the economic facts of the industry and the practical administrative problems of carrying out the primary purpose of the [Natural Gas] Act * * *" (R. 541d–552d). While making clear that it would "not permit a back-door approach to indi-

vidual cost-of-service under the guise of avoiding confiscation * * *" (R. 551d), the Commission stated that it would permit producers to petition for special relief from the area rates it was fixing (R. 551d, 656d–660d). The Commission did not deem it feasible to attempt an exhaustive delineation of the situations in which such relief might be afforded, but did point out that in many, and perhaps most, instances where a basis for relief from the area rate might be demonstrated it would probably be sufficient to permit the abandonment of unprofitable sales. The Commission's order contemplates that the prospective area rates would become effective immediately, subject to later adjustment if a proper showing for relief were made, but that refunds would not be ordered while a petition for special relief was pending (R. 660d).

B. THE TWO-PRICE SYSTEM

Concluding, as had the examiner, that the evidence supported the producers' claims that the gas industry now has and utilizes a substantial capability to search for gas reservoirs separately from oil reservoirs, the Commission found that a system which priced new gas-well gas (the only gas to which this directional searching applies) on a basis different from that used in pricing all other gas (*i.e.*, flowing gas) should be adopted as the best means of providing fair prices to the producer while also assuring adequate supplies for the present and future consumer (R. 563d–572d).

C. COST BASIS OF THE AREA RATES

The Commission held that the cost of "gas-well gas" (as distinguished from gas produced from oil

wells as a byproduct of oil production), determined from composite industry data, should be used as the yardstick for determining just and reasonable area rates (R. 573d–574d), rejecting contentions that area rates should be fixed primarily on the basis of negotiated contract prices (R. 552d–558d, 573d–574d). The rate for new gas-well gas was based chiefly on the current national cost of finding and producing gas; it is designed to ensure that the producers will have sufficient inducement to replenish exhausted reserves and meet increases in demand (R. 563d–569d, 574d–612d, 800d–810d). The rate for old gas-well gas was determined primarily on the basis of the historical costs of gas-well gas in the Permian Basin (R. 624d–639d, 810d–824d). As a check on its determination of these historical costs, the Commission also back-trended the new gas-well gas cost (R. 639d–645d). The results under the two methods were similar (*ibid.*). Processed oil-well gas—which the Commission found could not be costed realistically—was found to have a value equivalent to old gas-well gas at the wellhead of the same quality, thus warranting the fixing of the same ceiling prices (R. 615d–624d).

In determining rates for both new gas-well and flowing gas of pipeline quality, the Commission made clear that the high 12-percent rate of return on the producers' investment (more than 5 cents per Mcf) which it was allowing for both new gas-well and flowing gas reflected, among other elements the "risk of finding gas of less than pipeline quality" in the Permian Basin (R. 602d, 614d, 633d, 1112d). The Commission's order requires deductions from the base rates

(the rates for pipeline quality gas) for gas not conforming to the quality standards established by the order (R. 645d–656d, 1107d),[14] the amount of the deduction (except for heating value, for which both upward and downward adjustments were provided) to be measured by the purchaser's cost of bringing the purchased gas up to pipeline quality. While the precise extent of specific deductions was unknown at the time of the decision, the Commission estimated that their overall impact would be to reduce the producers' revenues by an average of .7 cents to 1.5 cents per Mcf (R. 1115d).[15]

[14] These standards include the maximum amounts of carbon dioxide, hydrogen sulphide, sulphur and water that pipeline quality gas may contain; the minimum pressure at which it may be delivered without deduction. As to heating value (Btu), the Commission found that in the Permian Basin gas having between 1000 and 1050 Btu's was of pipeline quality. Accordingly, proportional upward or downward adjustments from the base rate were provided for gas outside this range. In the original order, these Btu adjustments were limited to new gas-well gas, but on rehearing, in response to the producers' contentions, they were made applicable to all gas (R. 1108d).

[15] In order to arrive at the exact deduction for each rate schedule, the Commission provided that the seller and buyer should first attempt to agree on the amount of such deduction, with the Commission prescribing the amount only if no agreement was reached. Agreements have now been filed and approved by the Commission with respect to substantially all gas subject to such deductions. See *Area Rate Proceeding (Permian Basin Area)*, Docket Nos. AR61–1, *et al.*, Order Accepting Quality Statements, January 6, 1967, and Errata Notice, June 9, 1967 (soon to be reported at 37 F.P.C. 52). This order reveals that the quality deductions for old gas-well gas and old residue deliveries, based on the 1960 volumes of record in this case, have an average impact of 0.78 cents and 0.86 cents per Mcf, respectively.

D. THE RATES PRESCRIBED

The Commission concluded that the just and reasonable Permian area rate for "new" [16] gas-well gas of pipeline quality was 16.5 cents per Mcf (including taxes) in Texas and 15.5 cents per Mcf (plus tax) in New Mexico;[17] and for all other gas (*i.e.*, "flowing" gas, comprising old gas-well gas and oil-well gas, including residue gas therefrom) of pipeline quality, 14.5 cents per Mcf (including taxes) in Texas and 13.5 cents per Mcf (plus taxes) in New Mexico (R. 570d–572d, 688d–689d). The Commission also found that the public interest required that every producer in the area should be free to collect a minimum rate of 9 cents per Mcf for pipeline quality gas even if his contract specified a lower rate (R. 669d–671d).

E. SMALL PRODUCERS

The Commission agreed with the examiner that small producers should receive special treatment and that any producer whose annual sales subject to the Commission's jurisdiction were less than 10 million Mcf of gas nationally should be classified as "small." While the examiner would have exempted small producers from direct price control, the Commission decided that the area rates should be applicable to small producers, but without downward adjustments for

[16] This was defined to mean all gas-well gas sold under contracts dated on or after January 1, 1961.

[17] The applicable Texas tax is uniform in all counties in the Permian Basin; the New Mexico tax rates vary, with the applicable tax ranging from about .9 cents to 1.15 cents.

gas of less than pipeline quality.[18] In addition, the Commission instituted a rulemaking proceeding (since completed) to relax the requirements for certificates of public convenience and necessity and annual reports by small producers (R. 675d–682d; 30 Fed. Reg. 10038).[19]

F. LIMITATIONS ON INCREASED-RATE FILINGS

The Commission imposed a moratorium on filing any increased rates in excess of the applicable area rate until January 1, 1968. The Commission found that, without "a moratorium, the conclusion of one area proceeding would only signal the beginning of the next, and just and reasonable rates for consumers would always be one area proceeding away" (R. 662d). It stressed that costs had remained stable since 1960 and were likely to continue so during the moratorium (R. 660–669d). But it also made clear that any interested party would be free to request the Commission to reopen the area proceeding to consider a modification of the moratorium.

The Commission also prohibited Section 4 rate filings based on indefinite escalation clauses unless the

[18] However, if a small producer chooses, with respect to a particular sale, to take advantage of upward Btu adjustments, he must also take into account all other quality adjustments for that sale (R. 675d).

[19] The regulations which have been adopted permit Permian small producers to make all existing and future sales under a single certificate, provided that the prices charged do not exceed the applicable area base rate; and required reports are limited to a single page annual statement. Order No. 308, 34 F.P.C. 1202; 18 C.F.R. §§ 157.40, 250.10, 250.11. Sales with applicable area rates above the base rate because of upward Btu adjustments may be made under separate certificates, and require rate schedules filings.

rates filed were at or below the applicable area rate (R. 682d–683d).[20]

G. REFUNDS

With respect to rates that had been collected subject to refund under Section 4(e) of the Natural Gas Act (a large number of such refund proceedings having been consolidated with the Permian area rate proceeding), the Commission ruled that, by further order, it would require refunds of the difference between the amounts actually collected and the amounts that would have been received under the applicable area rate, taking into account quality adjustments (R. 672d–675d).

4. THE COURT OF APPEALS' DECISION

Petitions to review the Commission's order were filed by numerous producers and the States of Texas and New Mexico, and on January 20, 1966, the court below stayed the effectiveness of the Commission's order insofar as it required rate reductions and refunds (XII R. 12–14).

On the merits, the court below sustained the order in a number of respects. It found no constitutional or statutory inhibition against the use of the area rate method for fixing independent producer rates, and held that the Commission had not abused its discretion in adopting that method (XII R. 31–38). It deemed reasonable the Commission's conclusions that competition could not be relied upon to establish just and reasonable rates, and that the Permian Basin was

[20] Clauses of this type are fully described in *Federal Power Commission* v. *Texaco Inc.*, 377 U.S. 33.

a proper rate area (XII R. 37–38). It upheld the Commission's adoption of the two-price system for new gas-well gas and flowing gas and of the date marking the division between the two (XII R. 28–40). It accepted the Commission's cost calculations (XII R. 40–41). It held that the Commission had authority to impose a moratorium on price increases above the area rate and that the Commission had reasonably exercised that power in the premises (XII R. 43–44). It also approved the Commission's treatment of small producers and its refund ruling (XII R. 46–49, 57–58).[21]

Nevertheless, the court set aside the Commission's order and remanded the case to the Commission for further proceedings. Basically, the court faulted the Commission for having failed strictly to match the producers' aggregate revenues under the area rates with their total costs. Specifically, the court found that no determination of the revenues which the area rates would produce could be made because the record (in its view) did not disclose the revenue impact of the quality deductions. The court refused to pass on the adequacy of the rate of return allowed on gas-well gas, since it believed that the Commission had made no finding as to the overall impact of the quality deductions, so that a determination of the adequacy of the

[21] The court also rejected contentions that Commissioners Black and Swidler were disqualified to participate because they had entered the proceeding with views on important economic matters in issue (XII R. 28–29); that in fixing rates the Commission had interfered with the taxing powers of the States of Texas and New Mexico; and that the Commission had inadequately considered the interests of the producing States (XII R. 29–30).

return allowance was impossible.[22] Relatedly, the court, noting that some Permian Basin contracts specify prices below the area rates, held that the Commission should have fixed minimum rates high enough to assure recovery of the "revenue requirements" of the Permian producers as a group (XII R. 55–57).

The court also found wanting the Commission's provision for special relief from area rates, finding the provision "so vague and nebulous that neither [the producers] nor a court can determine what relief is being granted," and holding that an "adequate savings clause should contain guidelines which if followed by an aggrieved producer will permit it to be heard promptly and to have a stay of the general rate order until its claim for exemption is decided." (XII R. 50–51.)

On rehearing, the court held that its original approval of the Commission's refund ruling had been erroneous. It concluded, instead, that no refund obligation could be imposed for any period in which there was a "group revenue deficiency." "In fixing an area rate," it said, "the Commission must consider the

[22] It also stated that the Commission had erred in treating the possibility of finding gas that was not of pipeline quality as a risk to be considered in determining the rate of return, rather than as an item of cost of service (XII R. 54); that it did "not understand" the Commission's reasons for using a range between 1000 Btu's and 1050 Btu's, rather than a fixed figure, as the pipeline-quality standard for heating value (XII R. 51–53); and that it was not deciding the producers' contention that they had not been given adequate notice that the Commission would prescribe quality standards in this proceeding (XII R. 52).

effect which past and potential refunds have on balancing the group revenues with group revenue requirements" (XII R. 88–89).

SUMMARY OF ARGUMENT

These consolidated cases bring before this Court the Federal Power Commission's landmark decision fixing maximum just and reasonable rates for independent producers of natural gas in the Permian Basin on an area basis. We shall urge in this brief that the Commission's order should be sustained in its entirety. We necessarily confine this summary to the salient points of our argument.

I

A. While public utilities conventionally are regulated on a company-by-company basis, whereby each regulated company is permitted to set a rate that will return its particular cost of service, nothing in the Constitution or the Natural Gas Act sanctifies that method of determining just and reasonable rates; any method that fairly accommodates the interests of both the consumer and the investor is permissible. Moreover, in *Wisconsin* v. *Federal Power Commission,* 373 U.S. 294, this Court expressly held that the Commission was free to experiment with area regulation of producers' sales.

The record of the instant proceeding establishes the appropriateness of that approach. It shows that while producer costs vary widely from year to year on an individual-company basis, in the long run the costs of most producers tend to approximate the industry aver-

age. A uniform area rate based upon that average should therefore be fair to producers and consumers alike. To be sure, through exceptional skill or good fortune some producers may hope consistently to experience lower costs. This is inevitable in any system of group pricing. It also affords an incentive to greater efficiency and prudence.

B. The area approach is not invalid because some producers' costs may exceed the area ceiling. The risk of loss is not created by the particular technique of regulation, but is inherent in the nature of the business itself. Even under the individual-company cost-of-service method, the Commission could not guarantee the producer against loss; the forces of the market would prevent him from recouping costs which exceeded prevailing contract prices whatever the rate allowed by the Commission.

Quite apart from these practical considerations, the high-cost producer would not be able to show that the area rate (if otherwise valid) was confiscatory or unreasonable as to him. To the extent that his excessive costs resulted from unsuccessful exploratory efforts, the Commission plainly would have no obligation to allow him to recoup them. The Commission does not authorize exploration, and it is not accountable for fruitless exploration. Nor has the producer an absolute right to obtain on every sale a rate of return which was deliberately set by the Commission in this proceeding at a very high level—12 percent—because of the risk of failing to find adequate quantities of high-quality gas. To the extent that a producer who has

brought in a well and dedicated his output to the interstate market cannot cover his outlays for production under the applicable area rate, the answer is that the Commission will normally permit abandonment.

Moreover, the obligation of a regulatory authority is to fix a rate that is reasonable not only to the regulated company but indeed to its consumers as well. This Court has repeatedly held that consumer protection is the primary objective of the Natural Gas Act. A producer has no absolute right, constitutional or statutory, to shift to the consumer the burden of his bad luck in failing to maintain costs which are in line with the industry's overall experience, as reflected in the area rates prescribed in this proceeding.

C. Perhaps situations will arise under area regulation where a particular sale should, in fairness, be accorded special treatment. The Commission allowed for that possibility by establishing a procedure whereby producers may seek exceptions from the applicable area rate (or other appropriate relief) when exceptional circumstances warrant. It indicated a number of situations in which the record suggested that such consideration was appropriate. It was not required to anticipate and specify all of the circumstances that might warrant special relief in the future.

Nor is the producer who seeks exceptional treatment entitled—by the very act of petitioning the Commission—to an automatic stay of the area rate's applicability to him. That would be a departure from settled practices in the issuance of stays of administrative orders and would invite frivolous applications filed solely for purposes of delay.

D. As an incident to establishing area rates, the Commission forbade the filing of any rate increase for a period of some two and one-half years from the date of its opinion. Clearly, the Commission had power under the Act to impose such a moratorium. Otherwise, it could fix rates only for six months at a time. And in the circumstances the step was a reasonable one, designed to avoid quick nullification of the area ceilings fixed in this proceeding. Since costs in the gas-producing industry have been generally stable in recent years, producers have no cause to complain. Should the cost picture change, they are expressly permitted, under the Commission's decision, to seek a modification of the moratorium.

Upon like authority, the Commission was justified in permanently prohibiting the filing of any price increase above the area level if predicated upon a so-called indefinite-escalation clause. Commission regulations approved by this Court in *Federal Power Commission* v. *Texaco Inc.*, 377 U.S. 33, had already proscribed the inclusion of such provisions in future gas contracts because they led to pricing practices wholly lacking in economic justification and caused serious administrative burdens. Here, it appears clear, operation of such clauses would impair the Commission's newly adopted pricing system.

II

The basic judgments of regulatory policy made by the Commission in implementing the area approach in the instant proceedings were also proper, and should be sustained.

First, the Commission quite rightly decided that area rates should be anchored to costs rather than contract prices. In this industry, the bargaining between sellers and buyers cannot be relied upon to establish a reasonable price to the consumer. Production is heavily concentrated in a few major sellers and each source of supply is ordinarily committed under contracts of 20 years or more. The noncompetitive structure of the market is aggravated by the fact that the interstate pipelines (which are the principal buyers of Permian gas) are mainly in the market to purchase large blocks of uncommitted gas reserves. At any given time, there is unlikely to be more than one or a few producers who have such reserves in a location from which the pipeline can conveniently take gas. Equally inimical to consumer interests is the fact that the pipeline purchasers lack the ordinary incentives to bargain vigorously for lower prices, since they are normally able to pass along any price increase that they incur. The pipelines' relative indifference to producers' prices, suggested by their lack of active participation in this proceeding, may also reflect the fact that many of them produce as well as transport gas.

Secondly, the Commission properly determined that adequate gas supplies for the future could most effectively be elicited by pricing new gas-well gas on a different cost basis from all other gas. Most natural gas in the Permian Basin has been found as a relatively unimportant by-product of a much more valuable resource—crude oil. The price of the by-product has

little effect on the incentive to search for new supplies of oil. However, recent advances in directional searching have enabled the industry to explore directly for gas reservoirs. To encourage this search, the Commission decided to set an area ceiling for new gas-well gas that, by covering the current costs of finding that gas, would encourage the industry to look for new reserves. It fixed a lower rate for other gas to avoid bestowing a gratuitous windfall on producers. As observed, the ~~support~~ supply of such gas is not materially responsive to price.

There is no anomaly in the fact that, under the two-price system, gas of the same quality sells at different prices. In a real sense, new gas-well gas is worth more to consumers, not because it is better gas but because the higher price is necessary to ensure an adequate gas supply for the future.

Nor is there merit to the producers' argument that they should be permitted to charge the new gas-well gas price for all the gas they sell, in order to assure sufficient company-wide revenues to support extensive explorations for new gas reservoirs. It may be true that initially the new gas-well gas revenues, alone, will not support a desirable level of exploration. But the record shows that the flowing-gas rate is quite adequate to produce the added cash flow needed for such efforts; that other sources of financing, besides gas revenues, are available to, and utilized by, producers; and that a new gas-well gas rate fixed at a level sufficiently high to reward the search for new gas reservoirs should elicit any necessary investment capital.

Thirdly, the Commission properly ruled that producers were not entitled to raise their existing contract rates to the area ceiling. A natural gas company is presumed capable of rendering adequate service at rates which it voluntarily negotiates, even if those rates are below the ceiling which the Commission sets. It may abrogate its contractual commitments only if it persuades the Commission that the contract rate is "so low as to adversely affect the public interest" (*Federal Power Commission* v. *Sierra Pacific Power Co.*, 350 U.S. 348). No such showing was made here as to contract rates above 9 cents per Mcf.

All indications, indeed, are that the producers' revenues will be quite adequate. Existing contractual commitments will not prevent charging the full area rate for newly discovered gas-well gas, and that in itself should go far to assure an adequate gas supply for the future. Moreover, many of the low-priced contracts in the Permian Basin involve by-product oil-well gas, and many are "Spraberry" contracts in which the producer in payment for the gas receives, in addition to a fixed contract rate for gas delivered, a substantial portion of the revenues from valuable liquids extracted from the gas by the purchaser. For these and other reasons, the danger that producers' revenues will be so low as to injure the public seems remote. Should there be any producer who is disabled by low contract rates from rendering adequate service, he is free to seek appropriate relief from the Commission.

By the same token, the Commission was justified in ordering the producers to refund the full amounts

by which past charges under individual contracts exceeded the applicable area rate—regardless of whether other sales were made below the ceiling. In the absence of a showing that a revenue deficiency due to low contract rates is likely to impair the ability of the producers to serve the public adequately, it would be quite impermissible to deny one group of consumers their refund remedy for unlawful charges because other consumers, by happenstance, were the beneficiaries of advantageous contracts.

III

Finally, the specific applications of the Commission's pricing method—its cost determinations; the rate of return allowed; the standards prescribed for determining when the area rate should be discounted because of the inferior quality of the gas; the use of the cost of old gas-well gas as a yardstick in the pricing of oil-well gas—were reasonable and should be sustained by this Court.

A. The court of appeals had before it the extensive discussion of the many specific cost issues by both the examiner and the Commission; and the issues were fully briefed and argued. It was justified in concluding that the Commission had made no legal errors in these determinations and it was not required to discuss each producer objection individually and in detail.

(1) While the data used in deriving the costs of gas-well gas was obtained from diverse sources, they were the best and most representative available.

Doubtless, cost data can be improved and refined as the regulation of producers matures; but the producers' insistence upon perfection and symmetry in data collection of a degree unattainable at present is, in the absence of any superior presentation by the complainants, merely a claim that any cost-based regulation must be deferred indefinitely.

(2) The Commission properly decided to use the average investment devoted to the production of gas of a particular vintage (year) as the rate base for determining the return on investment to be allowed in the new gas-well gas rate. Only thus could the Commission fix a constant rate for such gas, rather than a rate that would have to be recomputed each year as the original investment in the vintage declined through depletion, depreciation and amortization. This method admittedly involves simplifications; but the record shows that it is not only administratively feasible but in its end result conforms to industry realities.

(3) The Commission properly used industry-wide drilling-cost data in computing the allowance for successful-well costs. There was no inconsistency in using national data limited to that reported by Permian producers in computing the net liquid credit for new gas.

(4) The lease-acquisition allowance was proper. Costs for the period most representative of current conditions were used, and adequate provision was made to reflect expense incurred in abandoned leases.

(5) In allocating dry-hole expenses between oil and

gas for purposes of computing the old gas-well gas exploration and development allowance, the Commission properly employed the modified Btu method. This established method recognizes that the essential common denominator of oil and gas is energy content (Btu's) but that other relevant economic factors must also be considered. The specific formula derived by the Commission using this method was reasonable.

(6) In fixing the production cost allowance for old gas-well gas, the Commission properly allocated such costs on leases where condensate and gas are produced together according to the relative cost of producing oil and gas separately. And, contrary to the contentions of some producers, it did not include non-salable carbon dioxide in calculating the volumes of gas over which the total costs of production should be spread in determining the unit allowance.

(7) Other cost contentions of the producers are equally unpersuasive. The Commission reasonably excluded federal income tax allowance, because the record did not show that producers paid any income tax on their gas revenues. The Commission properly computed the working-capital allowance, using methods which have been found appropriate for this purpose in the past.

B. The court of appeals held that the Commission had failed to appraise the impact that the deductions from the base area rates necessitated by quality deficiencies would have on the revenues of the pro-

ducers. The court overlooked the fact that while the record did not permit a determination to be made of the specific costs to particular pipeline companies of removing specific impurities, it showed—and the Commission found—that, on the average, Permian gas would have to be discounted within a range of .7 to 1.5 cents per Mcf from the area rate for pipeline quality. Moreover, in fixing the area rates the Commission allowed a higher rate of return than usual—12 percent, or more than 5 cents per Mcf—expressly to cover, *inter alia,* the risk of finding substandard gas for which a quality deduction would have to be made. The Commission was not required to treat the deduction for expenditures by the pipeline as a cost of the producer. And the 12 percent rate of return was clearly adequate.

C. Gas that is ready for pipeline use as delivered has greater value than a similar quantity of gas that requires compression or must first be processed to remove impurities. Accordingly, price differences based on quality are reasonable. In the instant proceeding, the Commission fixed standards for gas of pipeline quality and specified that the parties to each sale should attempt to agree on the appropriate price adjustment that would reflect the cost of raising the gas to that quality. This procedure for dealing with the problem of gas of inferior quality was sound and has proved eminently workable. The specific quality standards fixed by the Commission are unexceptionable. There is no merit, finally, to the producers' objections that notice was not given that quality standards would be in issue in the area proceeding.

D. The Commission's use of wellhead gas-well gas

costs as the bench mark for pricing other gas sold at the tailgate of extraction plants was also reasonable. In pricing oil-well gas—which represents two-thirds of the sales from the Permian area—the Commission found that specific costs derived for such by-product gas could not be realistically ascertained and that the two types of gas (wellhead sales of gas-well gas and tailgate sales of oil-well gas) have the same value in the marketplace. In these circumstances, the Commission reasonably fixed the price for oil-well gas sales at the level of the old gas-well gas costs. The Commission's adoption of one ceiling price for all old gas-well gas whether sold at the wellhead or after plant processing was also economically sound and consistent with past industry practices.

ARGUMENT

INTRODUCTION

Commonly, although by no means invariably, rates in regulated industries are fixed by the regulatory authorities at the level of each company's particular costs, including an allowance for a fair return on the capital invested in the enterprise. Since costs vary from company to company, so—under this method—do rates. This is the approach followed by the Federal Power Commission in fixing the rates of interstate natural gas pipeline companies, and the approach initially contemplated by the Commission when it first attempted to regulate interstate sales by independent producers of natural gas in 1954.

In the instant proceeding, the Commission, for the first time, fixed producers' rates on an area basis. Proceeding under Section 5(a) of the Natural Gas

Act, which directs it to fix "just and reasonable rates" for interstate sales of natural gas companies, and Section 4(e), which empowers it to disallow increased rates not shown to conform to that standard and to order the refund of any excess, the Commission prescribed uniform rates (and directed corresponding refunds) in the case of all independent producers in the Permian Basin of Texas and New Mexico, a major gas-producing area which accounts for more than 10 percent of the nation's total interstate sales of natural gas. These rates were based on composite area-wide or, for some items, industry-wide cost data, rather than on the experience of individual companies, and, as mentioned, are uniform rather than scaled to each producer's particular costs. The rates establish a ceiling for all gas flowing under existing contracts; they also establish the maximum initial prices at which the Commission will normally certificate new gas sales in the Permian Basin. See Section 7(c) of the Act.

A number of Permian producers sought judicial review of the Commission's rate-fixing order in the court below. Various consumer interests joined the Federal Power Commission in its defense. The court sustained the order in part but set it aside in other respects. Both sides successfully invoked the certiorari jurisdiction of this Court, and as a result all aspects of the Commission's order are before the Court for decision. We urge that the order be sustained in its entirety.

We divide our argument into three parts. In Part I we consider general challenges to the area approach.

Those producers who contend that—quite apart from its specific implementation by the Commission in this proceeding—such an approach is impermissible advance three arguments, all of which, we urge, lack merit: (1) that the Natural Gas Act does not sanction any departure from the individual company cost-of-service method; (2) that the area approach is not adapted to the needs and conditions of present and future consumers and investors in the producing end of the natural gas industry; and (3) that the area approach is confiscatory insofar as it may prevent a producer whose costs are higher than the average industry costs on which the area rates are based from making a profit. The final contention draws into question the adequacy of the Commission's provision for exceptional circumstances; its moratorium on rate increases above the area level; and its prohibition against the filing of rate increases which result from the application of certain types of contractual provisions for escalation and would pierce the applicable rate ceiling.

In Parts II and III, we turn from broad issues touching the permissibility of the Commission's area approach and consider its implementation in the orders here attacked. We focus first (in Part II) on the basic judgments of policy underlying those orders—that composite cost data, rather than contract prices, should be the basis of the area rate; that new gas-well gas (gas contracted for after January 1, 1961, found in wells that produce gas as the major product, rather than as a by-product of crude oil) should be priced on a different basis from other gas in order to

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encourage a search for new gas supplies; that the Permian producers are not entitled to raise all of their prices to the area ceiling without regard to the limitations imposed by their contracts; and that the Permian area was properly delineated. That leaves for discussion in Part III the particular judgments made by the Commission—relating to costs, rate of return, quality standards, and the pricing of by-product oil-well gas—in fixing the area rates that it believed to be just and reasonable.

I

AN AREA APPROACH TO REGULATING THE RATES OF INDEPENDENT PRODUCERS OF NATURAL GAS IS ENTIRELY APPROPRIATE AND WITHIN THE COMMISSION'S PREROGATIVES

A. ANY METHOD OF RATEMAKING THAT FAIRLY ACCOMMODATES THE NEEDS AND INTERESTS OF CONSUMERS (FUTURE AS WELL AS PRESENT) AND INVESTORS IS PERMISSIBLE UNDER THE CONSTITUTION AND THE NATURAL GAS ACT

In many areas of the economy we rely upon the impersonal forces of the market, as expressed in the bargaining between sellers and buyers, to establish a reasonable price for goods and services—optimally, the lowest price that will attract the necessary capital for business efficiency and growth. But in other areas—where competition is lacking or found wanting in vigor, or where the market otherwise fails as a regulatory mechanism—the Legislature has determined that government must assume (often in

conjunction with other controls) the function of establishing a price that reconciles the interest of consumers in low prices with the capital needs of the industry.

The natural gas industry is one of these areas. In common with other ratemaking statutes, the Natural Gas Act directs the regulatory agency (the Federal Power Commission) to fix rates that are "just and reasonable." As Mr. Justice Black, concurring in *Federal Power Commission* v. *Natural Gas Pipeline Co.*, 315 U.S. 575, 606–607—the case that sustained the constitutionality of the Natural Gas Act—explained, "The requirements of 'just and reasonable' embrace, among other factors, two phases of the public interest: (1) the investor interest; (2) the consumer interest"; both must be reconciled. *Id.* at 608. And in its next major decision construing the Act, this Court not only repeated that the "rate-making process under the Act, i.e., the fixing of 'just and reasonable' rates, involves a balancing of the investor and the consumer interests", but also made clear that the primary purpose of the Gas Act was the protection of consumers. *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591, 603, 610. See, also, *Atlantic Refining Co.* v. *Public Service Commission of New York*, 360 U.S. 378, 388.

The necessity for an accommodation of the two interests when they collide was strikingly stated in *Covington & Lexington Turnpike Co.* v. *Sandford*, 164 U.S. 578, 596, involving a scheme of turnpike regulation: "When the question arises whether the legislature has exceeded its constitutional power in prescribing

rates * * *, stockholders are not the only persons whose rights or interests are to be considered. The rights of the public are not to be ignored. It is alleged here that the rates prescribed are unreasonable and unjust to the company and its stockholders. But that involves an inquiry as to what is reasonable and just for the public. * * * The public cannot properly be subjected to unreasonable rates in order simply that stockholders may earn dividends."

Consistently with these decisions defining the basic goals and requirements of public utility regulation, we find nothing in the Natural Gas Act, or in the Constitution,[23] that prevents the Power Commission from adopting any ratemaking method it reasonably deems adapted to the regulatory purpose, so long as the rates fixed under it represent a fair accommodation of the interests of the consumers and investors concerned. The method traditionally used in much public utility ratemaking—fixing for each company the particular set of rates that will cover its costs and in addition provide its stockholders with a specified "fair" return on their investment in the enterprise—is not ordained by the Act.

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[23] A rate reasonable under the Natural Gas Act does not violate the Fifth Amendment. *Federal Power Commission* v. *Natural Gas Pipeline Co.*, 315 U.S. 575, 586. And area regulation has repeatedly been sustained against constitutional challenge. *E.g.*, *Nebbia* v. *New York*, 291 U.S. 502; *United States* v. *Rock Royal Co-op.*, 307 U.S. 533; *Sunshine Anthracite Coal Co.* v. *Adkins*, 310 U.S. 381; *Bowles* v. *Willingham*, 321 U.S. 503; *New York* v. *United States*, 331 U.S. 284; *Ayrshire Collieries Corp.* v. *United States*, 335 U.S. 573. Whether an otherwise reasonable area rate would confiscate the property of the exceptionally high-cost producer is discussed *infra*, pp. 58–64.

We treat this issue but briefly here, since it was very recently resolved in the Commission's favor. *Wisconsin* v. *Federal Power Commission,* 373 U.S. 294 (the second *Phillips* case). After this Court, in the first *Phillips* case (*Phillips Petroleum Co.* v. *Wisconsin,* 347 U.S. 672), held that producers were subject to regulation under the Natural Gas Act, the Commission instituted a proceeding to fix just and reasonable rates for Phillips' gas sales using the same individual-company cost-of-service approach that it customarily follows in pipeline cases. Finding that approach ill adapted to the radically different conditions of the producing industry, the Commission eventually dismissed the proceeding insofar as rates for the future were concerned, and announced that it would shift to an area approach. Its order of dismissal was challenged as an abuse of discretion. One of the contentions, fully briefed and argued, was that the Commission's action was improper because an area approach is impermissible. This Court disagreed (373 U.S. at 308–309):

> * * * If we believed that such a departure from present concepts had little, if any, chance of being sustained, we would be hard pressed to say that the Commission had not abused its discretion in terminating this § 5(a) proceeding while undertaking the area experiment. For if area regulation were almost sure to fail, and if the individual company, cost-of-service method of determining the reasonableness of rates had been abandoned, then there would be virtually no foreseeable prospect of effective regulation. * * *

> But to declare that a particular method of rate regulation is so sanctified as to make it highly unlikely that any other method could be sustained would be wholly out of keeping with this Court's consistent and clearly articulated approach to the question of the Commission's power to regulate rates. * * *
>
> More specifically, the Court has never held that the individual company cost-of-service method is a *sine qua non* of natural gas regulation. * * *

The court's observation that courts[24] have never undertaken to prescribe the ratemaking formula which must be used in regulating natural gas companies, but have instead allowed the Commission broad discretion to select the appropriate method, is unquestionably accurate. The debate between exponents of the individual-company cost-of-service method, on the one hand, and of the area rate approach, on the other, is of relatively recent vintage. However, the underlying question whether the Gas Act requires the Commission to employ a particular ratemaking formula first arose in the context of whether the agency was obliged to allow a pipeline a return taking account of the current value of its properties (the method of *Smyth* v. *Ames*,

[24] Certainly, the Act itself contains no direction on how to arrive at "just and reasonable" rates. Nor does the legislative history (see *infra*, pp. 44, 46).

169 U.S. 466) or was free to adopt the "prudent investment" method, which focuses on the original investment in the regulated company. That question was laid to rest in *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591, which upheld the power of the Commission to fix rates by the then unorthodox prudent-investment method.

The producers here challenging area rates *per se* would have it that the unorthodoxy of one generation of Commissioners fixed an inviolable dogma for the next. It is the method permitted in *Hope*—the individual-company cost-of-service method employing a prudent-investment rate base—that these petitioners now argue is the only proper method of rate regulation, from which the Commission may not depart in its novel task of regulating the prices of independent producers. In *Hope*, however, the Court took pains to avoid any suggestion of such a limitation (320 U.S. at 600–601):

> * * * Congress * * * has provided no formula by which the "just and reasonable" rate is to be determined. It has not filled in the details of the general prescription of § 4(a) and § 5(a). It has not expressed in a specific rule the fixed principle of "just and reasonable."

The Court went on to state its holding in terms which preclude fastening upon the Commission any specific method of ratemaking (320 U.S. at 602):

> We held in *Federal Power Commission* v. *Natural Gas Pipeline Co.* [315 U.S. 575,] *supra*, that the Commission was not bound to the use of any single formula or combination of for-

> mulae in determining rates. Its rate-making function, moreover, involves the making of "pragmatic adjustments." *Id.*, p. 586. And when the Commission's order is challenged in the courts, the question is whether that order "viewed in its entirety" meets the requirements of the Act. *Id.*, p. 586. Under the statutory standard of "just and reasonable" it is the result reached not the method employed which is controlling. * * *

The refusal of the Court in *Hope* to adopt or approve the cost-of-service method as such (although it upheld rates fixed by that method) was particularly significant in light of the argument there advanced by the Power Commission. The agency sought to have its order sustained by arguing that although the cost-of-service method had not been expressly written into the statute, Congress intended that method to be used insofar as constitutionally possible.[25] The argument was not accepted. The *Hope* decision, in short, rejected the substance of the very contention now advanced by certain of the producers.[26]

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[25] *Federal Power Commission* v. *Hope Natural Gas Company*, No. 34, O.T. 1943, Brief for Petitioners, pp. 36–39. Of course, this argument was made exclusively with reference to pipeline regulation, long before it was determined that producers were also subject to the Act.

[26] Notwithstanding these views of the Supreme Court in second *Phillips* and *Hope*, a number of producers place great reliance on the following reference in *Bowles* v. *Willingham*, 321 U.S. 503, 517, to the then-recent *Hope* case: "under other price-fixing statutes such as the Natural Gas Act * * * Congress has provided for the fixing of rates which are just and reasonable in their application to particular persons or companies." That statement was made when the only natural gas

It is argued that the Court, in *Hope,* rejected area ratemaking as a permissible method under the Gas Act because the majority refused to endorse a similar method suggested by Mr. Justice Jackson in dissent for dealing with the pipeline's own gas production. But what the Court held was simply that it would not *require* the Commission, in regulating pipelines,[27] to use an area rate method for determining the cost-of-service allowance for gas produced by the pipeline itself (rather than purchased), since in its view the Commission was free to use any method so long as the end result was reasonable. Subsequently, in *Colorado Interstate Gas Co.* v. *Federal Power Commission,* 324 U.S. 581, 601, the Court expressly noted that the Commission was not precluded from using an area rate approach in pricing gas production: "Some have thought that to be the wiser course."

The courts of appeals (including the Tenth Circuit in the instant case) have similarly refrained from reading into the Natural Gas Act (or the Federal Power Act) an inflexible directive to use any specific

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companies being regulated under the Gas Act were pipeline companies, which were—as they still are—regulated under the individual company cost-of-service method. Thus, the Court's language contrasting group regulation under the rent control law with individual company regulation of pipelines cannot be read as support for the proposition that rate regulation of producers under the Gas Act must also be based on an individual company approach. As producers have long urged and the courts have recognized, the business of producing gas involves economic and regulatory problems quite different from those encountered in the business of transporting gas by pipeline.

[27] Again, we note that no question of regulating independent producers was before the Court.

ratemaking method. *E.g., Panhandle Eastern Pipe Line Co.* v. *Federal Power Commission,* 143 F. 2d 488, 491–494 (C.A. 8), affirmed, 324 U.S. 635; *Cities Service Gas Co.* v. *Federal Power Commission,* 155 F. 2d 694, 698–699 (C.A. 10), certiorari denied, 329 U.S. 773; *Interstate Natural Gas Co.* v. *Federal Power Commission,* 156 F. 2d 949, 951 (C.A. 5), affirmed, 331 U.S. 682; *Pennsylvania Water & Power Co.* v. *Federal Power Commission,* 193 F. 2d 230, 241–243 (C.A.D.C.), affirmed, 343 U.S. 414; *Bel Oil Corp.* v. *Federal Power Commission,* 255 F. 2d 548 (C.A. 5); *Forest Oil Corp.* v. *Federal Power Commission,* 263 F. 622, 626 (C.A. 5).[28]

The cases are wholly consistent with the legislative background of the Natural Gas Act. To be sure, Congress viewed the Act as providing "for regulation along recognized and more or less standardized lines." H. Rep. No. 709, 75th Cong., 1st Sess., p. 3. But it was not uncommon, even then, for "just and reasonable" rates to be determined by group or area, as well as individual company, methods. The Secretary

[28] In *City of Detroit* v. *Federal Power Commission,* 230 F. 2d 810 (C.A.D.C.), certiorari denied, 352 U.S. 829, the court rejected the Commission's decision to fix the price which a pipeline could charge its ratepayers for gas produced from its own wells on the basis of the unregulated field price at which the pipeline purchased gas in the area, stating, *inter alia,* that unless cost of service "is continued to be used at least as a point of departure, the whole experience under the Act is discarded * * *." 230 F. 2d 818–819. In the second *Phillips* case, this Court noted that, whatever the court may have meant in *City of Detroit,* it did not have before it any question relating to the area rate method. 373 U.S. at 310, n. 16.

of Agriculture, operating under a statute containing virtually the same ratemaking provisions as the Natural Gas Act,[29] had—with this Court's approval—long fixed maximum just and reasonable rates for all stockyard marketing agencies of a particular yard on the basis of stockyard-wide cost data rather than the costs of individual agencies. *Tagg Bros.* v. *United States,* 280 U.S. 420; *Acker* v. *United States,* 298 U.S. 426; *United States* v. *Corrick,* 298 U.S. 435.

As this example illustrates, area ratemaking is no novelty. The Federal Communications Commission has for many years fixed maximum just and reasonable rates for international telegraph common carriers on a "bell-wether" basis, again under statutory rate provisions similar to Sections 4 and 5 of the Gas Act. It has refused, citing its statutory mandate to provide the public with "adequate facilities at reasonable charges" (47 U.S.C. 151), to fix rates "so that all carriers engaged therein may earn a fair return on the fair value of their property devoted to that service or even make some profit in their operations." *Postal Telegraph-Cable Co.,* 5 F.C.C. 524, 527. See, also, *Western Union Telegraph Co.,* 25 F.C.C. 535, 577–580. Under the Interstate Commerce Act, divisions of rates among groups of rail carriers were set on the basis of typical evidence even before express statutory authority for group ratemaking was added to the Act in 1920. See *New England Divisions Case,* 261 U.S. 184, 196–199. The levels of railroad

[29] Compare Sections 4 and 5 of the Gas Act, Appendix, *infra,* pp. 173–176, with Sections 306 and 310 of the Packers and Stockyards Act, 1921, as amended, 7 U.S.C. 207, 211.

rates, as well as divisions of joint rates, are set on the basis of group data. *New York* v. *United States*, 331 U.S. 284, 315–332. Other examples of group pricing include *Nebbia* v. *New York*, 291 U.S. 502 (milk prices); *Aetna Ins. Co.* v. *Hyde*, 275 U.S. 440 (insurance rates); *Sunshine Anthracite Coal Co.* v. *Adkins*, 310 U.S. 381 (coal rates); *Munn* v. *Illinois*, 94 U.S. 113 (warehouse rate); *General Passenger-Fare Investigation*, 32 C.A.B. 291 (air fares). Taxi cab fares are a familiar example of rates set on a group, not an individual-company, basis.

It is thus too late in the day, we submit, to maintain that governmental price-fixing is inflexibly required to proceed on a company-by-company basis, either generally or under the Gas Act.

B. THE COMMISSION HAD SOUND REASONS FOR CONCLUDING THAT AREA RATES FOR INDEPENDENT NATURAL GAS PRODUCERS WOULD FAIRLY ACCOMMODATE THE CONSUMER AND THE INVESTOR INTERESTS

We have urged that the Commission is not precluded as a matter of law from fixing area rates for natural gas companies. The adequacy of the reasons of regulatory policy that impelled the Commission to adopt this approach rather than the individual company cost-of-service method need not detain us long. An agency's choice between legally permissible ratemaking methods is entitled to great judicial deference (*Federal Power Commission* v. *Natural Gas Pipeline Co.*, 315 U.S. 575, 586, 607 (concurring opinion); *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591, 602; *Wisconsin* v. *Federal Pow-*

er Commisison, 373 U.S. 294), involving as it does an expert judgment on highly technical issues. This precept is especially apt here. The Commission turned to the area approach only after years of unsuccessful effort to adapt the individual company approach to the peculiar conditions of the producing phase of the gas industry. It acted upon a copious record exploring all relevant questions in great detail. And it articulated its reasoning in an opinion which is distinguished for its care and clarity.

The agency's choice of the area method as appropriate to the needs of the independent gas producers' industry must, if rational, be respected. This record supports that judgment—and more. We think it has been clearly demonstrated that in this industry the area approach is far preferable, from both the consumer and the investor standpoint, to the method it replaced—a method that in the present context proved neither rational nor workable. We believe, in short, that this Court was on sound ground in its second *Phillips* decision when it stated (373 U.S. at 310):

> We recognize the unusual difficulties inherent in regulating the price of a commodity such as natural gas. We respect the Commissions' considered judgment, backed by sound and persuasive reasoning, that the individual company cost-of-service method is not a feasible or suitable one for regulating the rates of independent producers. We share the Commission's hopes that the area approach may prove to be the ultimate solution.

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1. A conventional public utility—an interstate pipeline, a local gas or electric company, a water or a tele-

phone company—has two attributes which, taken together, permit effective regulation of its rates on the basis of its individual costs: a predictable correlation between the size of the prudent investment in its facilities and the amount of service rendered to the public; and (whether because it has an exclusive franchise or because it is a natural monopoly) little or no competition in rendering that service. Normally, the regulated company must obtain a certificate of public convenience and necessity in order to construct or extend its facilities, and the certificate will be withheld unless the regulatory authority is satisfied that the cost of the service rendered the ratepayers (operating costs plus capital costs, including a fair profit) will be commensurate with the value of that service. And the existence of a virtually assured market guarantees that the investor will be consistently able to earn a fair return under rates calculated by reference to the company's cost of service.[30] It was for such conditions that the individual company cost-of-service method was devised. But the conditions of the gas-producing industry are radically different.

The Federal Power Commission does not control the construction or expansion of facilities used to discover and produce natural gas, by certificating such operations where it may fairly be predicted that the value of the gas found to the consumer will exceed the producer's investment and refusing to certificate them otherwise. Nor could it. There is no predictable cor-

[30] A recent study of the electric industry observes that no investor-owned electric utility has failed for more than a generation. Metcalf and Reinemer, *Overcharge* (1967), p. 25.

relation between the investment input in any specific gas exploration activity and the marketable output. Like all prospecting, exploring for natural gas is a highly risky and uncertain business. The same investment may yield a dry hole, a marginal well, a moderately productive well, or a bonanza, depending upon luck as much, perhaps, as on extraordinary skill. Consequently, the variations in the cost of producing gas of identical quality are enormous. Not only do different producers tend to have different costs in any given year (R. 380e–416e, 493e–533e, 628e, 1014e–1022e), but an individual company's costs will often fluctuate widely from year to year (R. 771–773).[21]

The consequences for regulation were discerningly discussed by Mr. Justice Jackson more than twenty years ago in the *Hope* case (320 U.S. at 649; dissenting opinion):

> The prudent investment theory has relative merits in fixing rates for a utility which creates its service merely by its investment. The amount and quality of service rendered by the usual utility will, at least roughly, be measured by the amount of capital it puts into the enterprise. But it has no rational application where there is no such relationship between invest-

[21] For example, it was shown by one witness (R. 383e) that the cost per foot of exploratory gas efforts of one company fluctuated from $23.41 per foot in 1955, to $29.85 in 1956, to $44.70 in 1957, to $37.26 in 1958, to $15.07 in 1959, to $23.56 in 1960, while another company's comparable costs varied from $24.64 in 1955, to $11.60 in 1956 to $71.13 in 1957, to $11.30 in 1958, no such wells in 1959, and to $52.40 in 1960.

> ment and capacity to serve. There is no such relationship between investment and amount of gas produced. Let us assume that Doe and Roe each produces in West Virginia for delivery to Cleveland the same quantity of natural gas per day. Doe, however, through luck or foresight or whatever it takes, gets his gas from investing $50,000 in leases and drilling. Roe drilled poorer territory, got smaller wells, and has invested $250,000. Does anybody imagine that Roe can get or ought to get for his gas five times as much as Doe because he has spent five times as much? The service one renders to society in the gas business is measured by what he gets out of the ground, not by what he puts into it, and there is little more relation between the investment and the results than in a game of poker.

The same gas that on an industry-wide or area-wide average costs 16 cents per Mcf to produce is not worth 40 cents (or even 17 or 18 cents) to the consumer merely because that is what it cost the unlucky, though not necessarily imprudent, producer to find and produce it. It would be obviously unjust to set the rate so high. It would also be impractical. Competition in the industry, although far from perfect, does fix a market price that the individual producer cannot greatly exceed.

This points up the proposition that conventional ratemaking theory, when applied to the producing business, could result in serious unfairness to produc-

ers as well as to consumers. Let us suppose that during the first decade of his operations a producer is fortunate and produces gas at a cost of 6 cents per Mcf, a figure, we shall assume, less than half the market price. Under the cost-of-service approach he will be permitted little more than 6 cents for the gas. Suppose, however, that in the ensuing decade, after his early discoveries have run dry, the same producer's costs skyrocket to 20 cents or 25 cents but the market price remains the same. Now, obviously, the market imposes a price well below cost even though conventional regulatory principles would permit a cost-plus return.

Traditional methods cause other anomalies when applied to producers of natural gas. Under the individual company cost-of-service method of regulation, the producer who takes the initial risk in a previously unexplored area and proves it productive will often derive the least reward, for he will presumably pay less for his leasehold rights, and therefore have a lower rate base, than those less enterprising producers who follow in his footsteps. Moreover, inasmuch as natural gas royalties earned by the owners of land are usually proportional to the unit price of the gas sold, the traditional rate-base method would invite royalty owners to lease their properties to the least efficient producers, whose high costs would entitle them to correspondingly high rates. If the costs of the individual producer are the sole determinant of price, it also follows that a rate which is reasonable for one owner of a well may be inadequate or

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excessive for a co-owner of the same well, so that different just and reasonable prices would exist for gas from a single well.[32]

No less important a consideration is the intolerable administrative burden of holding repeated rate cases for each of the thousands of independent producers subject to the Commission's jurisdiction. The Commission's opinion in the second *Phillips* case spelled out in detail the magnitude of this task (24 F.P.C. 537, 545–546). As of September 1960, 3,372 independent producers had 11,091 rate schedules and 33,231 supplements to these on file with the Commission. The experience of the first six years of producer regulation led the Commission, at that point, to estimate that nearly 13 years would be required in order for its staff to

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[32] This consequence is akin to the "delirious results" which Mr. Justice Jackson attributed to the rate-base method when he remarked in *Colorado Interstate Gas Co.* v. *Federal Power Commission*, 324 U.S. 581, 610:

"* * * These orders in some instances result in three different prices for gas from the same well. The regulated company is a part owner, an unregulated company is a part owner, and the land owner has a royalty share of the production from certain wells. The regulated company buys all of the gas for its interstate business. It is allowed to pay as operating expenses an unregulated contract price for its co-owner's share and a different unregulated contract price for the royalty owner's share, but for its own share it is allowed substantially less than either. Any method of rate-making by which an identical product from a single well, going to the same consumers, has three prices depending on who owns it does not make sense to me."

This was, of course, before it was established by the first *Phillips* case that the Commission has jurisdiction over independent producers.

dispose of the cases then pending and that the prospect of its reaching a current status was remote.

2. The area approach adopted by the Commission in this proceeding overcomes these difficulties and provides a method of regulation reasonable from the standpoint of both consumer and investor. We have noted that the cost of any one producer at a particular point in time does not (except by chance) describe the average, typical or reasonable cost prospects for any producer—even himself, since there is no reason to assume that a producer will have the same costs in the next or in succeeding years. However, the record of this proceeding does indicate that a producer's costs tend to average out over the years (R. 771–773) and that, on an industry or area basis, a substantial degree of stability in costs exists from year to year (*e.g.*, R. 778, 1194–1198, 208d–209d, 400e–401e).

This evidence strongly supports the feasibility and fairness of establishing uniform area rates based on average costs.[33] Under that method, the average producer will recover his costs over the long run; his good years will balance his bad; his costs will tend to approximate the group's experience. Some producers, to be sure, may do better than the average and so earn more on their investment than the return allowed in the area rate. The producer who finds large reserves will be able to achieve greater profits than a producer whose exploration results in dry holes or marginal wells; the producer who operates efficiently

[33] We consider *infra*, pp. 80–84, a contention by some producers that contract prices rather than costs should have been the basis of the Permian rates.

and with economy will make more money than the producer who manages his business poorly. This, too, has its merits. Area pricing provides a strong incentive to prudence, economy and skill which individual-company cost-plus pricing would not provide in an industry like oil and gas production where individual cost norms are impossible to fix. And greater economy and prudence should, in the long run, keep the industry's costs down.

Thus, the consumer directly benefits from area pricing.[34] Moreover, an area rate based on area costs is economically realistic. It is no mere coincidence that the industry itself follows area pricing; that, as the record clearly shows (R. 1125e, 115e, 262–263, 1859–1864), gas of similar quality generally sells at the same contract price, irrespective of the individual producer's costs; and that producers themselves are guided by general group experience (R. 1640–1642). It is the economics of the industry, not regulatory whim, that dictates an area approach. A producer who agreed to sell at a price just above his cost gas that he had produced very cheaply would be foolish, because he would be making no allowance for the abnormally high costs that he could expect to incur in other explorations. The abnormally high-cost producer who fixed a price that would return his full costs would find no buyer.

[34] Only one party—Hunt, a producer—challenges the area rate approach on the ground that consumers will pay more under that than under an individual-company cost-of-service approach. This point was not raised in the application for rehearing to the Commission; Section 19(b) of the Gas Act prevents it from

Lastly, area regulation of producers' rates has the great advantage that it can be administered. For obvious reasons, "considerations of feasibility and practicality are certainly germane" to a choice of rate-making methods. *Chicago & North Western Ry.* v. *Atchison, Topeka & Santa Fe Ry.*, 387 U.S. 326, 342; *Bowles* v. *Willingham*, 321 U.S. 503, 517. As the Commission explained (R. 548d–549d), the area approach has enabled it to dispose of hundreds of individual rate cases in this single proceeding. When the four other pending area rate proceeding are completed, the Commission will have priced about 90 percent of the gas moving in interstate commerce. The establishment of area rates should also greatly facilitate proceedings to determine the propriety of increased rates and proceedings looking to the certification of new gas sales. Assuming a successful termination of

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being raised for the first time on judicial review. *E.g.*, *Panhandle Eastern Pipe Line Co.* v. *Federal Power Commission*, 324 U.S. 635, 649; *Federal Power Commission* v. *Colorado Interstate Gas Co.*, 348 U.S. 492; *Sunray Mid-Continent Oil Co.* v. *Federal Power Commission*, 364 U.S. 137, 157; *Wisconsin* v. *Federal Power Commission*, 373 U.S. 294, 307. At all events, the argument is wide of the mark. The Commission concluded that rates determined on an individual company basis would not reflect the economic needs of the independent gas producing industry, could not be meaningfully determined and hence would not provide an adequate tool for assuring consumers of adequate gas supplies. Hunt does not contest that conclusion directly, although he assumes, contrary to the Commission's findings, that individual company costs can be computed in a meaningful way. But Hunt's studies are based on arrays of information from individual companies which, while relevant to show the range of company costs at a particular time, are not meaningful for determining individual-company rates.

the instant proceeding, it is clear that the Commission has devised an administratively feasible solution to the immense problem of regulating thousands of independent producers.

C. THE COMMISSION'S AREA APPROACH IS NOT INVALID MERELY BECAUSE AN OCCASIONAL PRODUCER MAY PERSISTENTLY EXPERIENCE COSTS THAT EXCEED THE AREA RATE

1. The problem is largely hypothetical

When rates are fixed on the basis of industry or group average costs, it is of course possible that some of the regulated companies will consistently fail to recover their costs. Actually, in the present context this problem seems more theoretical than real. We have seen that in the gas-producing industry the costs of the individual producer tend in time to approximate the group average. Some variation from that norm is doubtless likely, but it would have to be considerable before even a colorable claim of confiscation was presented. This is because the area rates fixed in the proceeding in two respects exceed what the individual producer could conceivably ask under the Constitution.

First, they include, as an item of recoverable expense, an allowance for anticipated unsuccessful exploration and development expenditures. This allowance for dry holes has been included because such expenditures, in a reasonable amount, are a necessary incident of providing a continuing supply of natural gas;[35] but a producer clearly has no "right" to be

[35] For this reason, the Commission expressly included in the allowance a major growth component to take into account the need to increase gas production to meet future demands.

reimbursed for dry hole expenses (cf. *Columbus Gas & Fuel Co. of Ohio* v. *Public Utilities Commission of Ohio,* 292 U.S. 398, 407), since—unlike a conventional public utility—he has no legal obligation to remain in business by replenishing his supplies of gas. He may not, without the Commission's leave, abandon existing production facilities used to make sales to the interstate market (*United Gas Pipe Line Co.* v. *Federal Power Commission,* 385 U.S. 83), but whether to drill additional wells is entirely his option. Hence he cannot demand reimbursement of the cost which might be incurred in fruitless efforts to find additional supplies. See *Wisconsin* v. *Federal Power Commission,* 373 U.S. 294, 318–319 (dissenting opinion).

Secondly, the rate of return used by the Commission in computing the area rates here was deliberately set at a high level—12 percent—in the expectation that some producers' costs would exceed the industry average.

In sum, the moderately high-cost producer has a built-in cushion in the form of a dry-hole allowance that he could not claim as a matter of right and a rate of return substantially higher than necessary to avoid confiscation. As for the unlucky producer whose costs consistently so far exceed the applicable area rate as to make that rate wholly inadequate, it is most unlikely that he would be saved by being permitted to establish a rate scaled to his individual costs; as mentioned earlier, this is not an industry where it is economically possible for the seller to charge whatever rate is necessary to return his costs.

But we emphasize that there is no reason to expect that, in fact, any producer will find it impossible to survive under the rates fixed in this proceeding.

2. In any event, no principle of law guarantees profits to high-cost producers

Occasionally, one finds language in opinions which suggests that a rate which is reasonable (in the statutory sense) and non-confiscatory (in the constitutional sense) is one that returns the investors in the regulated enterprise a fair profit on their prudent investment. *E.g., Federal Power Commission* v. *Hope Natural Gas Co.,* 320 U.S. 591, 603, and cases there cited. These references must be understood in context; they invariably occur in cases where the regulatory process is directed at an individual company and where there are few guide posts other than that company's legitimate costs. This Court has clearly indicated, by its ruling in *Bowles* v. *Willingham,* 321 U.S. 503, 516, that a different standard is appropriate in an area case. The Court there upheld the lawfulness of wartime rent control legislation authorizing the Price Administrator to fix, without advance hearings, rents that were "generally fair and equitable." It reasoned, 321 U.S. 503, 518–519:

> It is implicit in cases such as *Nebbia* v. *New York,* 291 U.S. 502, which involved the power of New York to fix the minimum and maximum prices of milk, and *Sunshine Anthracite Coal Co.* v. *Adkins, supra,* which involved the power of the Bituminous Coal Commission to fix minimum and maximum prices of bituminous coal, that high cost operators may be more seriously

> affected by price control than others. But it has never been thought that price-fixing, otherwise valid, was improper because it was on a class rather than an individual basis.

And even earlier, in *Tagg Bros.* v. *United States,* 280 U.S. 420, the Court had affirmed a group rate order under the Packers and Stockyards Act, recognizing that the earnings of the agents subject to the order would vary; in fact, some of the agencies simply would not make any money. See 29 F. 2d at 755.

To be sure, the Court in *Willingham,* as one basis for rejecting constitutional objections, stated that no question of "taking" was involved since there "is no requirement that the apartments in question be used for purposes which bring them under the Act" (321 U.S. at 517). It quickly added, however, that "[o]f course, price control, the same as other forms of regulation, may reduce the value of the property regulated. But, as we have pointed out in the *Hope Natural Gas Co.* case (320 U.S., p. 601), that does not mean that the regulation is unconstitutional." 321 U.S. at 517. And, in any event, the fact that gas producers must have the Commission's permission to discontinue sales to the interstate market does not significantly distinguish the present case. Section 7(b) of the Gas Act confers upon the Commission broad power to authorize abandonment. In practice, the Commission has consistently authorized abandonment at the point when costs from a particular well equal or exceed anticipated revenues, since

> * * * [u]nlike the case of some public utilities which cannot abandon service without

> harming the public dependent thereon, we will seldom have a situation in which a particular producer's abandonment of some or all of its sales in the area will significantly affect the purchasing pipeline, to say nothing of the ultimate consumer. * * * [R. 659d.] [36]

As a practical matter, then, if the producer brings in a productive well and dedicates his output to the interstate market, he will normally be compelled to work it only so long as the area rate covers his operating outlays; when it ceases to do so, he will be permitted to switch to the intrastate market (see note 36).[37] In these circumstances, *Bowles* v. *Willingham* teaches that he has no right to demand a rate covering his costs of selling in the interstate market. And we have already seen that if a producer fails to bring in a productive well he cannot insist on reim-

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[36] The producers' argument below that the possibility of obtaining abandonment authorization does not provide a realistic alternative to obtaining an above-the-ceiling rate is plainly inconsistent with their assertion that group ratemaking is justifiable under other statutes where the regulated companies are free to discontinue service. Indeed, in view of the substantial intrastate markets for natural gas, the abandonment possibility open to producers seems at least as meaningful as the alternative of closing up a house or apartment—the landlord's recourse under the rent-control statute involved in *Bowles* v. *Willingham*, *supra*. Only about 60 percent of the natural gas produced in this country is sold interstate. For instances where the Commission authorized abandonment to permit intrastate sale, see *Joe Ballanforte, Sr.*, F.P.C. Docket No. G–18434 (August 1, 1967); *Trunkline Gas Co.*, F.P.C. Docket Nos. CP 67–101, etc. (May 3, 1967); *Transcontinental Gas Pipe Line Corp.*, 34 F.P.C. 584.

[37] He could of course challenge an arbitrary refusal to permit abandonment.

bursement for the cost of his fruitless efforts. Whatever his experience, then, a producer dissatisfied with an area rate that is otherwise valid has no sound basis for claiming confiscation.

Although no more is required, we point out that even under the company-by-company method of regulation there is no inflexible requirement that a regulated company be permitted to charge a rate that will cover its costs. It is entitled to a reasonable rate, to be sure, and one element that must be considered is the investor interest. But the consumer interest must also be considered. A regulated company has no absolute right to charge a rate that, from the consumer's standpoint, is unreasonably high. Judicial expressions to the effect that the reasonable rate is one that covers the regulated company's costs correctly state the general principle, but do not—and were not intended to—lay down a rigid rule applicable even where the individual-company cost-of-service method operates unfairly to the consumer. This Court has steadfastly rejected any such absolute: "The rights of the public are not to be ignored. * * * The public cannot be subjected to unreasonable rates in order simply that stockholders may earn dividends. * * * If a corporation cannot * * * earn dividends for stockholders, it is a misfortune for it and them which the Constitution does not require to be remedied by imposing unjust burdens upon the public." *Covington & Lexington Turnpike Road Co.* v. *Sandford,* 164 U.S. 578, 596–597 (*supra,* pp. 39–40). To the same effect see *Acker* v. *United States,* 298 U.S. 426; *San Diego Land and Town Co.* v. *Jasper,* 189 U.S.

439; *Tagg Brothers* v. *United States*, 29 F. 2d 750 (D. Neb.), affirmed, 280 U.S. 420.

There is thus no requirement in the law that the consumer of natural gas should be asked to "bail out" the unlucky producer who persistently exceeds average industry costs. The risk of failure, we stress, is endemic to the gas-producing industry. Every producer knows that if he has consistently high costs, he will be priced out of the market in the long run. To hold him to an area rate based on the group average cost—a rate that includes an allowance for the risk of not achieving that cost—does not defeat his reasonable expectations. And, unlike the conventional public utility, he can seek to cut his losses by leaving the interstate market. Certainly, no greater protection of investor interests is mandated by either constitutional or statutory principles.

D. THE COMMISSION HAS LEFT OPEN THE POSSIBILITY OF AN EXCEPTION TO THE AREA RATE IN UNUSUAL CIRCUMSTANCES

1. It is premature to challenge the adequacy of that provision

Our analysis indicates that nothing in the Constitution or in the Natural Gas Act required the Commission to provide exceptions to the area rates. Nevertheless, the Commission established a procedure whereby individual producers may seek relief from the applicable area rate. (R. 550d–552d, 656d–660d.)[38] This should dispel any residuary concern that the area approach involves dangers of serious unfairness to individual producers.

[38] This procedure is available not only for exceptionably high cost sales but in any circumstances in which it can be shown that a different rate from the applicable area rate would be in the public interest.

While deeming it impossible to specify all of the circumstances in which relief from the area rate might be appropriate, the Commission did suggest several. It stated that for prospective sales of "flowing" gas [39] a producer would be able to obtain relief where the applicable area rate failed to cover his out-of-pocket or cash expenses (R. 657d–658d). With respect to past sales, the Commission said that a producer would not be required to make refunds that would deprive him of amounts sufficient to cover his out-of-pocket operating expenses in the Permian Basin for the period involved (R. 659d–660d). It indicated some other instances in which relief from the area rate might be appropriate (R. 620d, 623d–624d),[40] but further advised that its examples were not intended to be exhaustive. It made clear that more

[39] Flowing gas is gas already discovered. Presumably future discoveries will not be dedicated to the interstate market if the cost of production at the indicated rate of flow exceeds the applicable area rate. The Commission suggested that ordinarily, in a case where the cost of producing flowing gas exceeded the area rate, it would authorize abandonment rather than an exception to the rate (pp. 61–62, *supra*).

[40] Thus, it indicated that special relief could be afforded if the establishment of the same ceiling price for gas-well sales at the wellhead and sales at the tailgate of an extraction plant were, in any given case, shown to make the processing operations under existing contracts with producers unprofitable; it noted, however, that the record indicated that normally this would not be the case (R. 623d–624d). In establishing the same ceiling for casinghead gas sales and sales of residue derived therefrom (see *infra*, pp. 155–160) the Commission again noted the availability of the special relief procedures if, contrary to its expectation in light of the record, such pricing resulted in a squeeze of the producer-processor (R. 620d).

would have to be shown by a producer seeking an exception from the applicable area rate than that its individual cost of service exceeded the average area costs on which the rate was based, since relief on such a ground would resurrect the rejected company-by-company approach and make the area rate a floor rather than a ceiling.

None of the producers before this Court has yet invoked the provision for seeking relief from an area rate. The dimension of the provision remain largely undefined. Surely it is too soon to suggest that the Commission will interpret it so grudgingly as to raise questions of arbitrariness.

2. The Commission was not required, at this stage, to specify in greater detail than it did the conditions under which exceptions to the area rate would be allowed

The court below faulted the Commission for failing to spell out all of the circumstances (other than potential confiscation) in which an exception to the area rate might be allowed. But we submit that the Commission was fully entitled, in its discretion, to postpone formulation of detailed exceptions to the area rates to a later date. The decision whether to announce criteria in advance or to delineate them through the process of considering each case as it arises is peculiarly the agency's. *Securities and Exchange Commission* v. *Chenery Corp.*, 332 U.S. 194, 202–203. No producer was injured by the Commission's procedure. Nor would it have been practicable, at so early a stage in the evolution of the area approach, to have attempted a detailed and definitive

a priori delineation of the nature and extent of exceptions that might be warranted by circumstances not disclosed in the record of this proceeding. A provision for special relief from a class rate, or for waiver of a general rule, is characteristically cast in sufficiently general terms to permit individual problems to be brought to the agency's consideration. And the generality of the Commission's provision here is consistent with escape and waiver clauses previously sustained by this Court. *E.g., New England Divisions Case,* 261 U.S. 184, 199; *United States* v. *Storer Broadcasting Co.,* 351 U.S. 192, 201; *Federal Power Commission* v. *Texaco Inc.,* 377 U.S. 33, 40.

It should also be noted that if situations allegedly justifying an "exception" are shown to be common to many producers, appropriate relief would be to modify the area rate itself.[41] See *El Paso Natural Gas Co.,* 35 F.P.C. 40, 44–45, set aside on other grounds *sub nom. Phillips Petroleum Co.* v. *Federal Power Commission,* 377 F. 2d 278 (C.A. 10), pending on petitions for writs of certiorari, Nos. 373, 380 and 385, O.T. 1967.

3. The Commission is not required to stay application of the area rate whenever a producer petitions for an exception

The court of appeals' ruling that any producer who claims an exception—whatever the grounds—is auto-

[41] Thus, the court below properly rejected (XII R. 50) Bass' claim to a special exception because of its allegedly unusual gathering facilities. The court found Bass had not shown itself to be exceptional in this respect (see R. 493d–497d). And the Commission correctly found (*infra*, pp. 155–160, 161–163) that producers who possess gathering facilities are not entitled, as a group, to a modification of the applicable area rate.

matically entitled to a stay of the area rate until his claim is decided is patently unsound. Such a requirement would greatly impede effective area rate regulation, and would simply invite requests for exceptions. The Commission's determination here that rates for the future should normally become effective pending action on requests for special relief[42] follows the procedure upheld in the *New England Divisions Case*, 261 U.S. 184, 204, and is consistent with the general requirement that a stay of an administrative order is not automatic but must be justified by a substantial showing. *E.g., Virginia Petroleum Jobbers Association* v. *Federal Power Commission*, 259 F. 2d 921 (C.A. D.C.); see *Federal Power Commission* v. *Tennessee Gas Transmission Co.*, 371 U.S. 145; *United Gas Improvement Co.* v. *Callery Properties, Inc.*, 382 U.S. 223, 230.

E. THE COMMISSION'S MORATORIUM ON RATE INCREASES WAS A REASONABLE AND PROPER INCIDENT OF FIXING AREA RATES

Section 4(d) of the Natural Gas Act requires natural gas companies to file notice of proposed changes in rates. The Commission may suspend the new rate for up to five months (Section 4(e)). After the change takes effect, the producer is subject to refund liability should he fail to prove that the new rate is just and reasonable.[43]

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[42] The Commission indicated, however, that no refunds would be required pending determination of such a request (R. 551d, 660d).

[43] A very substantial number of the proceedings consolidated by the Commission in this case are proceedings under Section 4(e) involving past increases.

An area proceeding would be quickly set at naught if the determination of the just and reasonable area rate were the occasion for a round of rate increases above the area level. Accordingly, the Commission in its order fixing area rates for the Permian Basin prohibited increased-rate filings in excess of the applicable ceiling until January 1, 1968, unless the producers should secure leave to file from the Commission in advance." The propriety of this moratorium is questioned.

1. The Commission had power under the statute to impose a moratorium on rate increases.

Section 5(a) of the Natural Gas Act empowers the Commission to

> * * * determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract *to be thereafter observed and in force,* and * * * fix the same by order * * *. [Emphasis added.]

And Section 16 specifies that the Commission may "perform any and all acts, and * * * prescribe * * * such orders, rules, and regulations as it may find necessary or appropriate to carry out the provisions of this act"; and that "[o]rders of the Commission shall be effective * * * in the manner which the Commis-

" While this Court's decision may post-date the expiration of the moratorium, the prohibition will invalidate a number of increases permitted to become effective as a result of the lower court's stay. Moreover, the validity of the Commission moratorium is important for other area rate proceedings.

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sion shall prescribe." These provisions, we urge, authorize appropriate moratoria on increased rates. The producers' claim that the Commission may fix prospective rates for six months at a time only is unsound.

Section 4, as noted above, provides the mechanism whereby changes not prohibited by contract or by Commission order become effective. But contentions that the provision is a grant of power that overrides all other parts of the Act have been uniformly rejected. *United Gas Pipe Line Co.* v. *Mobile Gas Service Corp.*, 350 U.S. 332 (rates prohibited by contract may not be filed); *Federal Power Commission* v. *Hunt*, 376 U.S. 515 (temporary certificate may be conditioned to prohibit increased rate filing during pendency of certificate proceeding); *United Gas Improvement Co.* v. *Callery Properties, Inc.*, 382 U.S. 223, 228 (permanent certificates may be conditioned to prohibit increased rate filings above specified price). See, also, *Federal Power Commission* v. *Texaco Inc.*, 377 U.S. 33, 42–43. As the Court stated succinctly in its *Mobile* opinion, 350 U.S. at 339:

> * * * § 4(d) is simply a prohibition, not a grant of power. * * * It does not say under what circumstances a change *can* be made. * * * [Emphasis in original.]

While the Commission has not limited rate filings when prescribing just and reasonable rates for pipelines on a company-by-company basis, the exercise of such authority is "neither novel nor unique as applied to group rates set after full agency hearing" (R. 665d–666d). For example, as the Commission pointed out in

its detailed discussion of the question (R. 660d-669d), the Interstate Commerce Commission, operating under statutory language almost identical to Section 4(d) and 5(a) of the Natural Gas Act, stated long ago that to "say that such an order may be defeated merely by the publication and filing of a rate higher than that prescribed by the order is to say also that the shipping public is not entitled to the protection of this Commission's orders during the period they are in force." *Nashville Traffic Bureau* v. *Louisville & Nashville Railroad Co.*, 53 I.C.C. 37, 38. And in *United States* v. *Corrick*, 298 U.S. 435, 439, 440, this Court held that where the Secretary of Agriculture, acting under the provisions of Section 310 of the Packers and Stockyards Act, 7 U.S.C. 211, prescribed "the just and reasonable rate or charge * * * *to be thereafter observed*" (emphasis in original), such rates "become the only lawful rates and so remain until the further order of the Secretary"; they cannot be altered by the unilateral increased rate filing of a particular marketing agency pursuant to Section 306 of the Act, 7 U.S.C. 207—a provision virtually identical to Section 4 of the Natural Gas Act.

There are, to be sure, differences between the Gas Act and the Interstate Commerce Act and Packers and Stockyards Act; but they do not undermine our point. Both of the latter Acts now provide expressly that orders under them, including those fixing just and reasonable rates, "shall continue in force until * * * further order, or for a specified period of time, according as shall be prescribed in the order." Section 15(2) of the Interstate Commerce Act, 49 U.S.C. 15(2); Section

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313 of the Packers and Stockyards Act, 7 U.S.C. 214. The Gas Act has no comparable provision. But we point out that the Court in *Corrick* did not support its conclusion by any reference to the language of Section 313. It relied, rather, on Section 310, which, like Section 5(a) of the Natural Gas Act, provides that the Secretary may prescribe the rates to be "thereafter observed"; and on its decision in *Arizona Grocery Co.* v. *Atchison, Topeka & Santa Fe Ry.*, 284 U.S. 370, which held that, where an agency "declares a specific rate to be the reasonable and lawful rate for the future, it speaks as the legislature, and its pronouncement has the force of a statute" (284 U.S. at 386).

The position of the Interstate Commerce Commission was adopted before the present language of Section 15(2) was added to the Interstate Commerce Act in 1920—at a time when the statute provided only that the Commission's rate orders "shall continue in force for such period of time, not exceeding two years, as shall be prescribed in the order of the Commission" (34 Stat. 589). The present language was added by the Transportation Act of 1920, § 418, 41 Stat. 484, in order to remove the express two-year limitation on the duration of such orders. The sponsor of the 1920 amendments explained on the House floor that "[w]e provide no limit, believing that it is wiser to have no fixed limit. * * *" 58 Cong. Rec. 8317.[45]

[45] The report of the House Committee on Interstate and Foreign Commerce had said that the "amendment also provides that orders of the Commission shall continue in force until its further order, in lieu of the existing law which provides that they shall continue in force for not exceeding two years." H. Rep. No. 456, 66th Cong., 1st Sess., p. 29 (1919).

The absence of specific language in the Gas Act automatically making its rate orders effective until further order thus means only that the Commission must take affirmative action if it desires to preclude immediate rate increase filings under Section 4; if any additional authority for such action, beyond that provided in Section 5(a) itself, is required, it is provided by the broad language of Section 16.[46]

2. The moratorium prescribed here was appropriate in the circumstances.

The producers also attack the moratorium on the grounds that the rates determined rest on a stale record; that there is no support for the Commission's view that costs are likely to remain stable; and that in the past the Commission has not imposed moratoria on Section 4 increased-rate filings when fixing pipeline rates. These contentions are unpersuasive.

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[46] See *Federal Power Commission* v. *Tennessee Gas Transmission Co.*, 371 U.S. 145, 154–155; *Federal Power Commission* v. *Natural Gas Pipeline Co.*, 315 U.S. 575, 583–585; *Public Service Commission of New York* v. *Federal Power Commission*, 327 F. 2d 893, 897 (C.A.D.C.). The cases upon which producers have relied are inapposite. In both *Mobile*, *supra*, p. 70, and *United Gas Pipe Line Co.* v. *Memphis Light, Gas & Water Division*, 358 U.S. 103, the rate filings involved sought to change company-made rates, not rates prescribed under Section 5 by the Commission after a comprehensive hearing fixing the highest just and reasonable rates to be charged for the future. Likewise in *Mississippi River Fuel Corp* v. *Federal Power Commission*, 202 F. 2d 899 (C.A. 3), and again in *Willmut Gas & Oil Co.* v. *Federal Power Commission*, 294 F. 2d 245 (C.A.D.C.), certiorari denied, 368 U.S. 975, none of the rates which were changed had been prescribed by the Commission.

The assertion that the Commission, in 1965, fixed rates solely by reference "to an already stale 1960 record" is inaccurate. To be sure, the price for old gas was based on a 1960 test year, but that price only governs gas which came into the market during or prior to that year. The new gas-well gas[47] price primarily reflects national data for years through 1963, projected to subsequent years. The record amply supports the Commission's conclusion (R. 661d-662d) that costs for new gas-well gas have been stable and are likely to remain so. One of the principal factors utilized in determining such costs is the cost of drilling, and the record shows a downward cost trend from 1958 to 1960 (R. 1004–1007, 1029–1030, 579d, 591d–592d, 801d–802d), with no basis to believe that this trend will soon be reversed. Various other cost trends similarly show rising costs to about 1958 with a decline thereafter (R. 136d–138d). As for other gas, the Commission adequately explained why its price would be even less likely to require immediate change because of current cost changes than the new gas-well gas price (R. 661d, 262d–263d).

The Commission would have been warranted in providing that the rates prescribed by it in the instant proceeding remain in force until modified by further Commission order.[48] The mere lapse of time in a rate

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[47] For a definition of this term, see *supra*, p. 19, n. 16.

[48] We do not of course contend that a failure to respond to materially changed circumstances would not constitute an abuse of power subject to judicial correction.

case does not show staleness. See, *e.g.*, *Interstate Commerce Commission* v. *Jersey City*, 322 U.S. 503, 514–515. In *United States* v. *Corrick*, 298 U.S. 435, the Court specifically approved the rejection by the Secretary of Agriculture of rates filed in the fall of 1935, although the rates prescribed by the Secretary, which were sought to be superseded, were based on data for 1931 and 1932, and it was alleged that "conditions had so changed that to prevent destruction of their business the appellees were compelled to adopt a new schedule of charges * * *". *Id.* at 437. The producers here have no complaint that the Commission imposed a less drastic moratorium—one limited to 28 months.

The fact that the Commission has not in the past deemed it necessary or appropriate to impose moratoria on increased-rate filings in fixed pipeline rates for individual companies provides no basis for the claim that the moratorium in this initial area rate case relating to hundreds of producers is impermissible. The need for such a moratorium obviously depends on the context in which rates are prescribed. In the early years after adoption of the Gas Act in 1938, prior to the great post-war expansion of the natural gas pipeline industry, the likelihood of imminent increased-rate filings was minimal; most rate orders involved reductions as the outgrowth of Section 5(a) investigations of existing pipeline rates and were not followed by increases. Beginning in the post-war period of rapid pipeline expansion, and throughout the 1950's, pipelines—primarily as a result of the rapidly spiralling costs of purchasing

gas—filed numerous rate increases.[49] Since the constantly increasing cost of gas seemed likely to require modification of even recently fixed rates (or rates which were still being evaluated), moratoria on increased pipeline rate filings were not appropriate in this period. Neither of these factors is present here.[50]

F. THE COMMISSION REASONABLY FORBADE RATE INCREASES ABOVE THE AREA RATE BASED ON CERTAIN PRICE-CHANGING PROVISIONS IN PRODUCER CONTRACTS

In addition to its imposition of a temporary prohibition on any rate increases above the applicable area rate, the Commission indefinitely forbade rate changes in excess of the applicable area rate if based on any indefinite contractual price-changing provision that would not be authorized under Section 154.93 of its regulations, 18 C.F.R. 154.93—including favored-nation, spiral-escalation and other highly inflationary clauses (see Statement, *supra,* pp. 7–11). However, in contrast to the regulations (sustained by this Court in *Federal Power Commission* v. *Texaco Inc.,* 377 U.S. 33)—which in effect proscribe all such clauses if contained in contracts executed on or after April 3, 1961—the Commission here did not totally proscribe the clauses in existing contracts; rather, it limited their effectiveness to the filing of

[49] It was, of course, just such increases which dramatized the need for Commission jurisdiction over producers, established by the first *Phillips* decision in 1954.

[50] It may be noted that from 1961 on, with the spiralling of producer prices largely checked, moratoria on increased rate filings have been included in most pipeline rate settlements—the principal method by which pipeline rates have been established in recent years.

increased rates not in excess of the applicable area rate.[51]

The Commission has express authority under Section 5 of the Act to modify contractual provisions after a hearing; and, as we have urged above, it has the power to prohibit, even indefinitely, the filing of rate increases under Section 4. It remains to consider whether these powers were exercised reasonably here.

The price-changing clauses in question, we submit, are clearly contrary to the public interest.[52] In that

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[51] As the court below noted (XII R. 44), even this restriction is not absolute; it may be relaxed by the Commission if an adequate showing is made pursuant to the waiver provisions of Section 1.7 of the Commission's regulations, 18 C.F.R. 1.7, or if a modification of the Commission's instant order is allowed pursuant to paragraph (L) thereof (R. 698d).

[52] In *Pure Oil Co.*, 25 F.P.C. 383, 388, the Commission determined such clauses to be contrary to the public interest, but took no action on that basis in that case. Simultaneously, the Commission issued Order 232 promulgating regulations which proscribed most indefinite price escalation clauses in subsequently executed contracts. 25 F.P.C. 379. Commission rejections of certificate applications based on these regulations, as modified by Order 242, 27 F.P.C. 339, have been affirmed in *Superior Oil Co.* v. *Federal Power Commission*, 322 F. 2d 601 (C.A. 9), certiorari denied, 377 U.S. 922; *Pan American Petroleum Corp.* v. *Federal Power Commission*, 352 F. 2d 241 (C.A. 10), on remand from *Federal Power Commission* v. *Texaco Inc.*, 377 U.S. 33; *Sun Oil Co.* v. *Federal Power Commission*, 353 F. 2d 86 (C.A. 3); *Sun Oil Co.* v. *Federal Power Commission*, 355 F. 2d 181 (C.A. 5).

The rationale which led the Commission to proscribe indefinite escalation clauses in its regulations was summarized by the Commission when it promulgated its Order 242. At that time, it stated in part (27 F.P.C. 339, 340):

"* * * Increases in producer prices, triggered by indefinite escalation clauses, have resulted in a flood of almost simul-

view, the Commission has already been sustained in this Court. *Texaco Inc., supra.* Such clauses are also inconsistent with the basis upon which the Commission determined just and reasonable prices in this area proceeding—a two-price system in which new gas-well gas is sold at a higher price than other gas (*infra,* pp. 84–87). The general regulations proscribing indefinite escalation clauses apply to contracts executed on or after April 3, 1961. The Commission's ruling in this proceeding, therefore, primarily affects indefinite escalation clauses covering sales of flowing, not new, gas. But limiting these clauses is highly important, since they would permit the escalation of flowing-gas prices to the new gas-well gas price level

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taneous filings. These filings bear no apparent relationship to the economic requirements of the producers who file them. The Natural Gas Act contemplates that prices, to be just and reasonable, be related to economic needs. The elimination of indefinite escalation provisions does not, of course, cut off other avenues by which a producer may make provision for filing for increased rates.

"Filings under indefinite escalation clauses have created a significant portion of the administrative burdens under which this Commission is laboring today. The Natural Gas Act contemplates that rate increases shall be sought when there is economic justification, but not that there shall be a chain reaction in a wide area whenever one producer in the area negotiates a contract at a new price level. The Act requires the Commission to give precedence to the hearing and decision of rate increases, but the complexity of indefinite price clauses requires it to spend an undue amount of time in their interpretation and application at the expense of making a prompt determination of the rate issues involved. Accordingly, in protecting the public against waves of increases which have no defensible basis, we also serve the need—which we believe we should take into account—of making the tasks of regulation more manageable."

and thereby disrupt the operation of the two-price system.

The producers charge that the Commission's action is inconsistent with its 1961 decision in *Pure Oil Co.*, 25 F.P.C. 383, 387–391, not to proscribe the indefinite escalation clauses involved there because the Commission believed such action might have invalidated the contracts in their entirety. Since the Commission has in fact only limited, not proscribed, indefinite escalation clauses, the concern expressed by the Commission in *Pure* has doubtful application here. Even if the Commission's actions were interpreted, however, as affecting a contract in such a material way as to nullify the entire contract, there would certainly be no injury to producers; they would then be free of contractual restrictions on their rate filings, although of course obliged to continue service. *Sunray Mid-Continent Oil Co.* v. *Federal Power Commission,* 364 U.S. 137.

II

THE COMMISSION'S BASIC JUDGMENTS IMPLEMENTING ITS AREA APPROACH ARE FULLY CONSISTENT WITH SOUND REGULATORY POLICY

Thus far, the focus of our discussion has been upon the basic structure and broad outlines of the area approach—its legitimacy as a regulatory tool. In this and the following part of the argument we consider the Commission's concrete implementation of that approach. We begin with the basic question whether the area rates should have been based on contract

prices rather than anchored, as the Commission concluded, to an assessment of average costs.

A. THE COMMISSION PROPERLY CONCLUDED THAT THE AREA RATE SHOULD NOT BE BASED ON FIELD PRICES

Some producers urge that, in fixing just and reasonable area rates in this proceeding, the Commission should have relied primarily—if not exclusively [53]—upon the contract prices negotiated between the producers and their pipeline purchasers. They reason that the forces of the market can, in the main, be relied upon to achieve the regulatory goal of "the lowest possible reasonable rate consistent with the maintenance of adequate service in the public interest." *Atlantic Refining Co.* v. *Public Service Commission of New York,* 360 U.S. 378, 388, 391. This argument rests fundamentally on the false premise that conditions of effective competition exist in the gas-producing industry. It has repeatedly been rejected

[53] The major producer group sponsoring this approach has recognized that other factors must also be considered for proper regulation, including costs. They would test the reasonableness of contract prices by "R/P" (reserves to production) ratios. As we discuss, *infra*, pp. 165–166, the Commission reasonably concluded that this ratio does not provide a workable regulatory tool. The additional claim is made that the Commission's costing techniques, unlike the contract-based method, fails to give adequate consideration to problems of supply, demand, directionality, etc., in establishing a rate that will elicit adequate gas exploration, development and production to meet future needs. As explained in the Commission's opinion (and those portions of the examiner's opinion adopted therein), and as elaborated in later parts of this argument, such matters were fully considered in fixing the various cost elements that compose the area rates.

by the courts in cases involving individual producer rates and initial prices at which producer sales are certificated. See, *e.g.*, *United Gas Improvement Co.* v. *Federal Power Commisison*, 290 F. 2d 133, 135 (C.A. 5), certiorari denied *sub nom. Sun Oil Co.* v. *United Gas Improvement Co.*, 368 U.S. 823; *Bel Oil Corp.* v. *Federal Power Commission*, 255 F. 2d 548 (C.A. 5), certiorari denied, 358 U.S. 804.

No natural gas producer has the monopoly power of a local electric company enjoying an exclusive franchise. But it does not follow that there is sufficient competition to provide assurance that the market price of natural gas approximates its cost (including a reasonable profit). The number of producers in the Permian Basin is misleading, for many are very small. Cf. *Federal Trade Commission* v. *Procter & Gamble Co.*, 386 U.S. 568, 578. About half of the sales in the Permian Basin for the interstate market are accounted for by only five producers, and 15 producers account for about three-fourths of all the sales (R. 275e–293e, 556d). These figures indicate an oligopolistic market, in which vigorous competition is unlikely to flourish. See Bain, *Industrial Organization* (1959), pp. 32–33, 131–132. Furthermore, the "relevant market for natural gas, in which price is determined, is the market for uncommitted reserves," not the market for current production (R. 410; see *United States* v. *El Paso Natural Gas Co.*, 376 U.S. 651, 660; Neuner, *The Natural Gas Industry* (1960), p. 6), present production being largely committed under contracts of 20 years or more. Therefore, as the Commission rightly observed (R. 556d), a "key fac-

tual question in determining whether there is effective competition is the amount of uncommitted reserves controlled by the large producers." The producers—who are in exclusive possession of the relevant facts—made no showing that the uncommitted reserves are widely distributed among the various producers (see R. 315–316), and, as the Commission noted (R. 556d), the pattern of sales suggests that a large percentage of the uncommitted reserves is probably controlled by relatively few.

It may be that there are non-regulated industries which are more highly concentrated, but that is no reason why the Commission should shirk its statutory duty to regulate natural gas producers. Moreover, the figures on concentration greatly understate the actual power over price that producers enjoy. At any one time, only a very few producers or producer groups are likely to have the large volumes of uncommitted reserves needed by a pipeline desiring to prepare for a major expansion, for the existence of large reserves is limited both as to size and location by natural conditions. Assuming that twenty producers control the bulk of reserves in the entire Permian Basin, one producer might still control all of the undedicated reserves near a particular pipeline's existing lines and be able to exact a monopoly price from the pipeline, which would find it costly to purchase gas in another location far from its existing facilities (R. 424).

Another reason why the market cannot be relied upon to keep prices down to a reasonable level is that the purchasers of Permian gas—the interstate pipelines serving principally California—have little incen-

tive to bargain vigorously with the producers. The history of pipeline gas purchasing is one of imperative recurring needs by pipelines to purchase large blocks of reserves under long-term contracts: either to start a pipeline, to enlarge it, or to remain competitive in expanding markets. The need for huge reserves increases a pipeline's willingness to pay high prices, especially since it can normally pass these prices on to consumers in the form of higher rates R. 429–430).[54] As noted at the outset of our argument, the Commission sets pipeline rates to cover the individual company's costs, including the cost of the gas it buys. And the pipeline encounters relatively little difficulty in recouping from its purchasers whatever it must pay the producers. Gas consumers represent by and large a captive market: as the examiner found (R. 117d), once residential and commercial consumers have installed gas-using equipment their demand for gas tends to be inelastic. Industrial consumers generally have a more flexible demand, but in Los Angeles County, where much of the Permian gas is consumed, natural gas is now required throughout a good part of the year because of local restrictions on the industrial use of fuel oil, imposed to combat air pollution.[55]

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[54] Consider, in this connection, the stance of the pipeline company (Tennessee Gas) in the so-called *CATCO* litigation. *Atlantic Refining Co.* v. *Public Service Commission*, 360 U.S. 378. Note, also, the failure of the pipelines to participate actively in this area proceeding, except as directed to do so by the examiner or the Commission.

[55] In California generally, the industrial demand for gas is less responsive to price than in other areas of the country (R. 117d).

That many pipelines are themselves producers is also relevant.[56] They have a direct financial stake in high producer prices. Finally, we stress that the rapid rise in the average price level reflects the prevalence of favored-nation and spiral-escalation clauses in the producers' long-term contracts with the pipelines, which have had an artifically inflationary effect (see Statement, *supra*, pp. 7–11).

In sum, there is ample support for the Commission's conclusion (R. 557d–558d) that "[w]hatever the degree of competition which may exist among producers it has not been effective to afford gas consumers the protection to which they are entitled under the Natural Gas Act."

B. THE COMMISSION PROPERLY CONCLUDED THAT A TWO-PRICE SYSTEM WOULD MOST EFFECTIVELY ENCOURAGE THE SEARCH FOR NEW GAS SUPPLIES AT THE LEAST COST TO THE CONSUMER

Having decided to anchor the Permian area rate to costs rather than contract prices, the Commission had next to determine whether all gas produced there should be treated alike or whether some segregation of costs according to the source of the gas would be appropriate. It chose the latter course. It determined the costs of new gas-well gas separately and set a different and higher rate for such gas.

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[56] Transwestern, one of the three pipelines in the Permian Basin and the pipeline that offered the highest prices in the area, was owned to a large extent by producers. Sixteen percent of its stock was owned by Monterey Oil Company prior to December 1960, and 32 percent was until this year owned by a subsidiary of Gulf Oil Corporation (R. 116d–117d).

1. The two-price system has a rational economic basis

Some natural gas is found in gas reservoirs and produced by gas wells; this is "gas-well" gas.[57] Other natural gas—"oil-well" gas—is found in crude-oil reservoirs and produced by oil wells. About two-thirds of the gas production in the Permian Basin has in recent years been oil-well gas.

Oil-well gas is a by-product of the search for oil, and a relatively minor one at that. Partly because gas can only be transported by means of very expensive pipeline facilities, partly because it is not usable as a motor fuel, natural gas is much less valuable than oil with an equivalent energy content (R. 112d–113d). The average value of the gas found in an oil reservoir is only about 1/17th the average value of the total products from such a reservoir (R. 139d). Oil-well gas cannot be produced separately from oil and its production is governed largely by conservation practices designed to control oil production. For these reasons, the price of gas has only a slight effect on the supply of oil-well gas. The examiner found (R. 139d–140d) that a very large increase in the price of gas would be necessary before the supply of oil-well gas was significantly affected—"an increase so large that it probably could not be carried out."[58] Gas pricing

[57] However, the term also includes "gas-cap" gas found in association with crude oil in oil reservoirs but produced by gas wells (R. 139d). Most gas-well gas is non-associated gas. See, generally, R. 567e.

[58] Although the price of oil-well gas may affect marginal decisions to drill or abandon, this effect is minor (R. 316–318, 140d).

policy thus cannot be an important instrument for creating incentives to find new supplies of oil-well gas.[59]

Until recently, the supply of gas-well gas was also largely unresponsive to price (*e.g.*, R. 421–422). This was because gas reservoirs were ordinarily found as an incident to the search for oil or for hydrocarbons in general—the industry being unable, in most areas, to direct its search to gas reservoirs as such (R. 418–419). Since total oil revenues greatly exceed gas revenues, even a sizable increase in the price of gas would increase only marginally the producer's incentive to expand the joint search (see R. 145d). This situation has changed considerably. The industry now can direct its exploratory efforts toward finding gas reservoirs; no longer can gas be found only as a by-product of the search for oil (*e.g.*, R. 557–559, 581, 142d–165d). To encourage the utilization of this newly discovered capability of searching for gas specifically, the Commission adopted in this case a system in which the current cost of new gas-well gas[60] —gas that can be located on a directional basis[61]—is determined independently as the basis for pricing such gas. Producers will not utilize their new-found ability to search for gas reservoirs unless the area rate is high enough to cover their current costs of finding and producing gas-well gas. And those costs are relatively

[59] The Commission, of course, does not regulate the price of oil.

[60] That is, gas committed after January 1, 1961 (see *infra*, pp. 91–92)

[61] Oil-well gas remains purely a by-product of oil production.

easy to ascertain. As one economist explained (R. 581):

> * * * If gas has its own search, it has its own costs, and the allocation problem ceases to intrude into the formulation of an economically realistic price for future gas—though of course it can in fact never be banished entirely. * * *

It does not follow that all gas should be priced on the basis of the current costs of gas-well gas. The new gas-well price is an incentive price, and the price fixed either for old gas-well gas or for oil-well gas, old or new, will have no significant effect in eliciting additional supplies of gas. The price for such gas must still be fair. But, since much of it was discovered in the past, when costs were lower, and some, indeed, was discovered when gas was a waste product (not even a marketable by-product), to price all gas at the higher current costs of gas-well gas would bestow a wholly gratuitous windfall upon producers (R. 576, 174d–175d, 565d–566d, XII R. 39).

Nor would a single price based on an average of historical and current costs provide the same incentive to explore for gas, even if such a price yielded the same total revenue on an area basis. If, as is here the case, the current cost of gas-well gas exceeds the average of current and historical costs, producers under such a single-price system would find little profit in directing their endeavors to finding new gas reservoirs.

2. The incentive to gas exploration provided by the system is proper and effective

The result of the Commission's analysis was the establishment of two area rates for Permian gas of similar quality—a higher rate for new gas-well gas, a lower rate for all other gas.[62] There is no anomaly in this. As we have explained, the function of the higher price for new gas-well gas, based on current costs, is to provide an incentive to explore for new supplies of such gas—the only kind substantially responsive to price. So long as such supplies are needed—and none denies that they are—it is entirely reasonable to require consumers to pay the price required to bring forth a commitment of such supplies. As Mr. Justice Jackson observed in his *Hope* opinion (*Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591, 653), price is a "tool" and should be employed "to induce private enterprise completely and efficiently to utilize gas resources, to acquire for public service any available gas or gas rights and to deliver gas at a rate and for uses which will be in the future as well as in the present public interest."

A comparable pattern has long been familiar in the home-mortgage field. The ceilings for interest rates on FHA or VA loans are periodically established on the basis of what interest rate will then elicit sufficient mortgage funds, even though the rates will remain constant for the life of the mortgages—twenty, thirty, or even more years. Changes in these ceil-

[62] We explain *infra*, pp. 155–163, why the Commission decided to price all gas other than new gas-well gas at the same level, using the costs of old gas-well gas as a yardstick.

ings may mean that a mortgage obtained one day will be substantially more expensive than one obtained on the same type of building a day earlier or later. No one suggests that this is an arbitrary system.

Nor is there merit to the argument that the rate fixed for new gas-well gas does not provide a dependable reward for the exploration it is intended to encourage, because the Commission could reduce the rate after the financial commitment to seek new gas supplies had been made by the producer in expectation of receiving the original price. Such uncertainties inhere whenever government fixes prices. Certainly, however, it cannot be assumed that the Commission will arbitrarily defeat producer expectations that it itself deliberately engendered to foster its regulatory goals (R. 569d). We assume that should the Commission some day lower the price of new gas-well gas, it would do so prospectively. Indeed, one of the major advantages of a two-price system is that it enables the Commission to set different prices for future vintages of gas without necessarily changing the price of gas already committed.

The producers argue for a single-price system based on current costs, on the ground that revenues for current exploration and development must be internally generated by sales of gas from whatever source. Even if the premise of this argument—that producers' gas revenues are the only source for financing new gas explorations—were sound,[63] the conclusion would not

[63] It is not (see *infra*, pp. 90–91).

follow unless the rates set by the Commission for both new gas-well and other gas, viewed together, were inadequate to generate a substantial cash flow. Actually, the flowing-gas prices allowed by the Commission provide plentiful revenues for investment in the search for new gas wells. Producers will receive a base price of 14.5 cents per Mcf for such gas, and although the average revenue is expected to be one to two cents less because of quality adjustment and the existence of contract prices lower than the area rate, only 4.35 cents of the revenue so received will represent out-of-pocket expenses related to lifting and selling the gas;[64] the remainder will be available for reinvestment. Many gas leases will generate additional net revenues from the sale of lease liquids. And for new gas-well gas, which will become increasingly important, the out-of-pocket lifting and selling costs are 5.9 cents, so that, taking the credited liquid revenues into consideration (R. 587d), as much as 13.7 cents will be available for reinvestment. It is apparent that these rates will be sufficient for the industry to finance a substantial portion, if not all, of its projected finding efforts out of its revenues from the production of gas.

And while the oil and gas industry will probably continue to generate the major portion of its own capital, there is no reason to expect internal financing of all of its exploratory activities; this has not been the pattern in the past (R. 914–916). Funds other than

[64] This figure is the sum of production expenses, including administrative and general overhead, production tax, regulatory expense, and ⅛ royalty based on the 14.5 cents ceiling (R. 634d, 639d).

gas revenues are available for investment in exploration and production. Newcomers put money into exploration and development (R. 616); revenues from other company sources can be invested in the search for new gas wells (R. 620–626); debt capital is available to producers,[65] and it can be used to finance growth (R. 617). To be sure, gas exploration and development must compete with alternative uses of available funds. But so long as the gas market continues to grow rapidly and the new gas-well gas price offers a fair return on current costs, one may expect the necessary funds to continue to flow to new gas (R. 623–625, XII R. 39).

3. The Commission's adoption of January 1, 1961, as the date of division between new gas-well gas and old gas-well gas was reasonable

The underlying reason for the two-price system, as we have seen, is the industry's recent recognition of the feasibility of exploration directed specifically to discovering new supplies of gas. There is accordingly no basis for applying the present cost of finding gas to gas found before directionality became significant. The Commission concluded that it first became significant in 1960 and that costs have remained constant since then. These factors, taken with the use of a 1960 test year to cost old gas-well gas and the announcement of the interim dual area pricing concept in the Commission's September 28, 1960, Statement of Policy, indicated that a cut-off date late in 1960

[65] On the average, about 15 percent of producer capitalization represents long-term debt (R. 565e, 642e, 599d).

would be appropriate. Choice of the year-end as the exact date was based on considerations of administrative feasibility (R. 571d).

Some producers argue that an incentive price is needed to elicit supplies even under existing contracts, because such contracts frequently dedicate gas from acreage warranting additional exploration, albeit the contract does not require full exploration. The Commission, on rehearing, expressly recognized that evidence presented in future proceedings might justify encouraging new discoveries from previously committed acreage by extending the new gas price to gas from new reservoirs found there and directed the matter be considered in the pending Hugoton Anadarko case. It reasonably concluded, however, that its present decision to apply the new gas price only to new gas-well gas contracts was the only one fully justified on the existing record (R. 111d; see, also, 166d–168d). So ruling, the Commission followed long-established policy of treating alike all gas from acreage committed under a contract. *E.g., Placid Oil Co.*, 26 F.P.C. 166.

C. THE PRODUCERS ARE NOT ENTITLED TO HAVE THEIR EXISTING CONTRACT PRICES RAISED TO THE AREA RATE. NOR ARE THEY ENTITLED TO OFFSET LOW CONTRACT PRICES RECEIVED IN THE PAST AGAINST THE REFUNDS THEY OWE TO PURCHASERS WHO WERE CHARGED MORE THAN THE APPLICABLE AREA RATE

1. A number of contracts between producers and purchasers of natural gas in the Permian Basin set a sales price below the applicable area rate fixed by the Commission in this proceeding. Must the Commission permit the producers to abrogate their contractual commitments and charge the area rate?

We think not. This Court held in *United Gas Pipe Line Co.* v. *Mobile Gas Service Corp.*, 350 U.S. 332, that under the Natural Gas Act rate regulation is superimposed on—not substituted for—private bargaining. In a companion decision, *Federal Power Commission* v. *Sierra Pacific Power Co.*, 350 U.S. 348, the Court expressly held that the Commission was not authorized to raise a contractual rate merely because it was below the lowest just and reasonable rate that the Commission could lawfully have prescribed.[66] It is presumed that regulated companies are able to fulfill their public obligations at rates to which they have voluntarily assented; they will not be permitted to escape their contractual obligation, the Court declared, unless the rate is so "low as to adversely affect the public interest—as where it might impair the financial ability of the public utility to continue its service, cast upon consumers an excessive burden, or be unduly discriminatory" (350 U.S. at 355). Correlatively, low rates for some sales do not warrant excessive rates for others. See *Federal Power Commission* v. *Tennessee Gas Transmission Co.*, 371 U.S. 145; *Hunt Oil Co.*, 28 F.P.C. 623, 626; *infra*, p. 97.

As the Commission expressly held, no showing was made in this proceeding that the public interest required the raising of low contract prices, except to the extent that they fell below 9 cents per Mcf for pipeline quality gas (R. 669d–671d). The only price fixed by the Commission that will have a significant

[66] The ruling was under the Federal Power Act, but the Court stressed that the Natural Gas Act was relevantly identical in this respect. 350 U.S. at 353.

effect on the supply of gas is the price for new gas-well gas. Obviously, there are no contract limitations on the sales price of gas yet to be found.[67] All other gas is the incidental by-product of the search for oil, and an adequate incentive to continue the production of such gas should exist so long as the incremental costs of lifting it from the ground (including royalties and production taxes) are met by the allowed rates (R. 514). Since those costs amounts to less than 5 cents per Mcf—part of which may be offset by related liquids revenues (see *infra,* p. 95)—it is apparent that the lifting costs will be amply covered, even under contracts priced near the Commission's 9 cent minimum.

Other factors also compensate for low contract prices. One is the low cost of oil-well gas—two-thirds of all the gas produced in the Permian Basin. The Commission fixed a single rate for oil-well gas and old

[67] While new gas sold prior to the date of the Commission's order was selling, on the average, at somewhat less than the allowed ceiling rate, this basically reflects that fact that during the period from January 1, 1961, to the date of the order (August 5, 1965) producers had been committing their gas supplies at the 16-cent guideline price for pipeline-quality gas specified for the Permian Basin by the Commission's Policy Statement 61-1, 18 C.F.R. 2.56. In allowing the new gas-well gas price for gas committed during this period, the Commission was attempting to accord the rate treatment it would have provided if the area proceeding had been immediately concluded. But this liberal retrospective application of the new gas-well gas price—which some of the consumer interests objected to because it could not actually affect the search for new supplies—should not require that the price of gas voluntarily committed during this interim at less than the ceiling price be raised.

gas-well gas, based on the cost of old gas-well gas; the cost of oil-well gas, it found, was lower, though by how much it could not accurately determine (see *infra,* pp. 155–159). And much of the oil-well gas remaining at low prices was committed at a time when such gas was still largely a waste product.[68]

In addition, about 20 percent of all sales of oil-well gas in the Permian area—including most of those shown in record exhibits as priced below the area ceiling fixed in this proceeding—are under "Spraberry-type" contracts (see *infra,* pp. 160–161).[69] These return to the producer, in addition to a fixed rate per Mcf of gas delivered (the only price shown on the exhibits), a percentage of the revenues received by the pipeline purchaser from the liquids it extracts from the gas after delivery. This substantial compensation[70] for the gas has not been included by the producers in computing their gas revenues for these sales.

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[68] For example, substantial sales by Shell Oil Company and Coltexo Corporation to Columbia Carbon, orginally begun in 1948 as sales for carbon black (R. 1101e, 236e, 247e; *Shell Oil Co.*, 25 F.P.C. 1316, 1319), remained at low prices. Similarly, a very large residue oil-well gas sale by Phillips under its Rate Schedule 18 to Northern Natural had been initiated under a 1952 contract at a time when much gas in the area had been flared. See *Permian Basin Pipeline Co.*, 12 F.P.C. 85, 90–92.

[69] Almost all of the volumes classified in the exhibits as casinghead gas sales were of the Spraberry type (R. 619d).

[70] As the Commission stated (R. 1113d), the full extent of such revenue is not disclosed by the record. In their exceptions, however, the Continental group stated that while liquid revenues varied, producers realize 5¢ to 6¢ per Mcf—or more—for liquids contained in gas produced from the Spraberry Field (Tr. 275753).

We conclude that the Commission was on sound ground in finding no cause for serious concern that the existence of contract rates below the applicable area rate would jeopardize the revenue needs of the producers. There is empirical confirmation of the soundness of this judgment. The Commission has computed the average revenue per Mcf of the Permian producers, using 1960 volumes and the rates on file at the end of that year (which reflect all contract limitations), at 12.9 cents for the old gas-well gas for which quality statements have been filed. This is but a shade below the 13-cent average that the Commission expressly found to be just and reasonable.[71] Factors mentioned earlier indicate that there is even less likelihood of deficient revenues in the case of oil-well gas.[72] Should there be any producer who cannot render adequate service due to low contract rates, he can avail himself of the opportunity to seek exceptional relief.

2. The Commission held (R. 673d–674d) that refunds would be required with respect to past sales for which the filed price exceeded the applicable area rate. But the court below, on rehearing (XII R. 88–89), held that no refunds could be ordered for any period in which the revenues of the Permian

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[71] The base rate, to be sure, is 14.5 cents, but the quality deficiencies estimated by the Commission would result in an average rate of 13 cents (R. 1115d). The Commission made provision for any revenue deficiencies due to substandard quality in the rate of return it fixed; we show *infra*, pp. 142–143, that this provision was adequate.

[72] The overall average rate found in the study just mentioned—including, that is, oil-well as well as gas-well gas—was 12.7 cents.

producers as a group were less than their revenue requirements. While this ruling is not entirely clear, it doubtless reflects the court's concern as to the impact on producers' overall revenues of contract prices below the area rates fixed in this proceeding; and it must mean—since the Commission cannot raise contract rates retrospectively, and require the purchasers to give refunds to the producers—that the court would permit the producers to retain excessive charges under some rate schedules to compensate for their failure to obtain the area rate in other contracts.

So ruling, the court ran counter to the holding in *Federal Power Commission* v. *Tennessee Gas Transmission Co.*, 371 U.S. 145, 153, that a natural gas company's

> * * * losses in the first instance do not justify its illegal gain in the latter. * * * The company * * * must, under the theory of the Act, shoulder the hazards incident to its action including not only the refund of any illegal gain but also its losses where its filed rate is found to be inadequate.

See, also, *Federal Power Commission* v. *Natural Gas Pipeline Co.*, 315 U.S. 575, 590. As the Commission noted (R. 673d), "[i]f one wholesale customer has been overcharged, it is little comfort to him to know that another customer has received a bargain." The anomaly is especially pronounced on the facts of this case. Well over half the contract revenues that are lower than the applicable area rate (excluding the deceptively low-priced Spraberry-type contracts, see, *supra*, p. 95) involve sales to Northern Natural Gas Company while most of the refunds due under

the Commission's order result from excessive payments made by El Paso Natural Gas Company.[73] Under the ruling below, El Paso's customers, who are located in California, Arizona, New Mexico and Texas, would be denied redress solely because some producers had voluntarily accepted lower payments from another pipeline, which serves the Midwest.

Nor is there any basis to suppose that requiring the excessive charges collected by the Permian producers to be refunded in their entirety will impair their ability to serve the public adequately. As observed, the producers have made no showing even that existing contract rates should be revised upwards to conform to the area rates. Certainly, they should not escape refund liability for past excessive charges because other sales were governed by unfavorable contracts since this fact is even less likely to affect future industry operations. Any producer who finds that his refund liability disables him from serving the public can seek appropriate relief from the area rate. It is

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[73] According to the refund reports filed by the producers through June 30, 1967, pursuant to the Commission's opinion in this proceeding, El Paso will receive, exclusive of interest, about $30 million out of total refunds of slightly less than $32 million listed for the period prior to September 1, 1965. About $24 million of El Paso's refunds relate to sales of residue gas not derived from new gas-well gas. Most of this is oil-well gas since in the Permian Basin very little old gas-well gas was processed (R. 621d). Northern will receive about $1.1 million, Transwestern about $300,000, and West Texas Gathering Company about $250,000.

We note that not all refund reports have been filed as yet; those that have been filed remain subject to Commission approval.

premature to conclude that the Commission will deny relief in instances where it is warranted in the public interest.[74]

D. THE COMMISSION COMMITED NO PROCEDURAL IRREGULARITY IN DELINEATING THE PERMIAN AREA

The Commission's delineation of the area in which a uniform rate would be proper is the initial judgment that it must make in each area proceeding. But we discuss it last here because the only challenge to the Commission's area determination is procedural: the producers' contention that they were improperly denied a hearing on the geographical propriety of the Permian Basin as a cost area.

We submit that the Commission did not abuse its discretion in deciding to proceed with this case on the basis of the well known area, leaving the possible revision of area boundaries to a separate proceeding. Expanding the area would have required joining addi-

[74] *Wisconsin* v. *Federal Power Commission*, 373 U.S. 294, requires no different result. There, to be sure, the Commission, in declining to order refunds with respect to a limited number of increased-rate filings relating solely to a past period, noted that the producer's costs for the test year had greatly exceeded its revenues. But that was not the sole, or even the controlling, reason for not ordering refunds. The record was insufficient to prescribe just and reasonable rates (this was, of course, one reason why the Commission in that case announced that it was switching to an area approach); and the Commission found that a new hearing, limited solely to the past rates on which refunds might be due, was not warranted. This Court, in affirming the Commission, noted the limited basis for the Commission's decision, pointing out that in another pending case the Commission had stated that refunds for specific rates might be warranted without regard to the company's unreimbursed costs on other sales. 373 U.S. at 306, n. 15.

tional parties and would have delayed fixing just and reasonable rates. And by declining to consider revision of the area boundary in this case (R. 3d), the Commission did not restrict the methods of ratemaking that would be considered in any way. The only consequence of its action was that whatever methods were adopted or data used, the rates fixed would, at least initially, apply only to the Permian Area (even if the logic of the method made the rates applicable elsewhere). In fact, much of the evidence presented and used was nationwide. In addition, evidence relating to several counties adjacent to the Permian Area was presented.[75] While no party sought to present cost data on an enlarged Permian Basin area, we note that data for these counties would have had a *de minimis* impact on the overall judgment in view of the fact that the combined sales from these counties was very small compared to the total Permian Basin gas supply.

Superior argues that the decision (R. 3d) not to change area boundaries in this case required a single rate, and precluded the fixing of sub-area rates, rates based on well depths, or rates based on the vintage of the gas. But plainly the Commission's determination not to expand the Permian Basin for the time being did not foreclose fixing rates within the area on the bases now suggested by Superior, or indeed on any appropriate bases.

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[75] This evidence included geological data for the three counties (R. 37–41, 15e), and well-drilling costs in Val Verde County, Texas (Tr. 30399). The Commission's staff presented gas-reserves evidence on Roosevelt County, New Mexico (Tr. 32594).

III

THE AREA RATES FIXED BY THE COMMISSION IN THIS PROCEEDING ARE JUST AND REASONABLE

Having urged that the Commission's basic policy judgments in formulating and implementing an area approach to regulating rates of independent natural gas producers in the Permian Basin were proper, we turn now to the propriety of the rates themselves. We deal here with the most technical of regulatory judgments—those resolving detailed questions of rate-making. The proper scope of judicial review is exceedingly narrow; we accordingly confine our argument to showing that the Commission's findings on these points had a reasonable basis. See *Federal Power Commission* v. *Natural Gas Pipeline Co.*, 315 U.S. 575, 585–586. The subjects in question may be categorized as follows: (1) the costing techniques employed by the Commission, and some of its specific determinations covering various items; (2) the adequacy of the rate of return on invested capital allowed by the Commission; (3) the propriety of establishing in this proceeding standards for determining gas of pipeline quality and of requiring deductions for substandard gas, and the reasonableness of certain of those standards; and (4) the use of the gas-well gas costs found in the proceeding as the basis for pricing oil-well gas (and residue gas derived from gas-well gas) as well.

The court below approved the Commission's cost determinations. It did not reach most of the issues involved in the other three categories of objections,

but we submit that this Court would be warranted in resolving all of the contested issues without remand to the court below for its initial consideration. So urging, we rely on the reasoning in this Court's recent decision in *Chicago and North Western Ry.* v. *Atchison, Topeka and Santa Fe Ry.*, 387 U.S. 326, 355-356:

> The District Court did not directly deal with these contentions, stating rather cryptically that in light of its conclusions on the revenue needs issues, "it is unnecessary to discuss [the cost issues]. However, no inference is to be drawn that the court is of the opinion that the [cost issues], or any other numbered issues not discussed in this opinion, are of the nature it would be required to decide should they be raised at some future time."
>
> The appellees argue that since the District Court failed to pass on the cost issues, we are precluded from doing so. It is true that we have occasionally stated that it is not our general "practice to review an administrative record in the first instance." *United States* v. *Great Northern R. Co.*, 343 U.S. 562, 578; *Seaboard Air Line R. Co.* v. *United States*, 382 U.S. 154, 157. But we think that policy is not applicable on the facts of this case. The presentation and discussion of evidence on cost issues constituted a dominant part of the lengthy administrative hearings, and the issues were thoroughly explored and contested before the Commission. Its factual findings and treatment of accounting problems concerned matters relating entirely to the special and complex peculiarities

> of the railroad industry. Our previous description of the Commission's disposition of these matters is sufficient to show that its conclusions had reasoned foundation and were within the area of its expert judgment. *B. & O. R. Co.* v. *United States,* 298 U.S. 349, 359; *New York* v. *United States,* 331 U.S. 284, 328, 335, 349. Thirteen years have elapsed since the complaints in this case were first filed. The appellees' attacks on the legal validity of the Commission's findings on cost are so insubstantial that no useful purpose would be served by further proceedings in the District Court. * * *

See, also, *United Gas Improvement Co.* v. *Callery Properties, Inc.,* 382 U.S. 223, 226–227; *Federal Power Commission* v. *Southern California Edison Co.,* 376 U.S. 205; *United Gas Pipe Line Co.* v. *Memphis Light, Gas & Water Division,* 358 U.S. 103, 114.

The public importance of completing the first area rate proceeding as soon as practicable need not be labored; it is vital to effective regulation of a fundamental industry. If there are infirmities in the Commission's detailed application of the area approach, they should be exposed now; if there are none, rate reduction and refunds (both stayed pending completion of judicial review) should be effectuated forthwith. In fact, as we shall urge, none of the producers' contentions concerning the details of the Commission's pricing determinations is substantial; and there is accordingly no justification for further delay in the effectiveness of these area rates.

A. THE CHALLENGED COST DETERMINATIONS OF THE COMMISSION WERE PROPERLY SUSTAINED BY THE COURT OF APPEALS

In attacking the Commission's cost determinations below, the producers challenged both the data sources used by the Commission and the determinations themselves. The court of appeals found that the Commission had committed no legal errors and sustained the Commission's exercise of judgment. A number of producers contend that in rejecting their multitudinous objections without a separate discussion of each, the court abdicated its reviewing responsibilities. But both the Commission and the hearing examiner had discussed in great detail the voluminous cost presentations (only a part of which are included in the extensive printed record) and set forth painstakingly the basis of their judgments on the contested questions. All of the issues—which are highly technical—were elaborately briefed. In these circumstances the court was not required to discuss each objection, thereby increasing "the length of [its] opinion to encyclopedic dimensions" (XII R. 41). Compare *Chicago & North Western Ry.* v. *Atchison, Topeka and Santa Fe Ry., supra.*

1. The Commission's data were obtained from the best and most representative sources available

A few of the producers have contended that the Commission's determination of the cost of new gas-well gas is not reliable because it is based on a synthesis of data derived from a number of independent statistical sources, rather than from one complete set of accounting records. One producer (Sun) has con-

tended in addition that the Commission's findings on the cost of *old* gas-well gas are unsupported because they are based on a composite of non-uniform—albeit complete—accounting records and because the underlying data—it contends—are unreliable in a number of respects.

a. The costing of new gas-well gas on the basis of data from diverse sources was necessary and proper

Among the sources of the studies of new gas-well gas cost used in this proceeding were several based on highly trustworthy publications, such as the Census of Mineral Industries, which is an official compilation by the Census Bureau of reports furnished to it under oath.[76] In addition, there was the Permian (or "Appendix") questionnaire. Prior to this proceeding no agency, public or private, had attempted to collect comprehensive cost information from all of the principal domestic producers. One agency might collect well-drilling costs; another might collect lease acquisition costs. One agency might separate oil-well data from gas-well data; another might merely report a lump sum. Since there was conceded to be no single existing source of data suitable for all the necessary elements of a cost study,[77] the Commission, in co-

[76] Other sources were studies by non-industry sources like the Chase Manhattan Bank, trade publications such as World Oil Magazine, and statistics collected or estimated by trade associations of oil and gas companies.

[77] See R. 113–114. The parties collaborated in preparing a list of recognized published data sources (R. 291–307), and the examiner ruled that he would not sustain hearsay objections to data from these sources (R. 309–310).

operation with the parties, proposed an elaborate questionnaire [78] to be sent to all Permian producers.

The parties were nevertheless unable to secure from this single source all of the cost data they needed. In particular, the proposals for determining the cost of new gas-well gas required information of a kind not normally contained in the producers' accounting records (and therefore not sought by the questionnaires), as well as information on gas reserves which producers strenuously contended must be kept confidential,[79] and which they were accordingly excused from furnishing (R. 38d, 47d).

In these circumstances, any witness who attempted to estimate the cost of new gas-well gas had no choice but to draw judiciously upon several sources of data. The few objecting producers do not suggest that any other procedure was possible, yet nevertheless deem it inadequate, thus implying the unacceptable proposition that the Commission's fulfillment of its responsibilities to the consuming public is to be frustrated until the oil and gas industry adopts one unified, all-inclusive system of statistical collection and disclosure.

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[78] The questionnaire was divided into three parts: Appendix A, which asked for the drilling costs of all producers; Appendix B, which asked for all of the costs of producers selling more than 10,000,000 Mcf of jurisdictional natural gas (some smaller companies, however, volunteered responses to Appendix B); and Appendix C, which asked for costs of operators selling less than 10,000,000 Mcf of jurisdictional natural gas. The Commission did not secure meaningful data from all of the small producers. Many lacked the accounting resources to supply all the data; many did not own operating interests.

[79] The responses to the questionnaires were available to both the parties and the public.

In this case, the witness upon whom the Commission principally relied was an experienced economist and statistician (R. 651–653), well aware of the pitfalls inherent in dealing with disparate data sources. His testimony (R. 1002–1046, 1416–1435) demonstrates patient and painstaking effort to develop consistent conclusions from the available information. A thorough cross-examination (R. 1441–1478, 1485–1514) further revealed the scrupulous care with which he had handled the available sources. Other expert witnesses, sponsored by the largest group of producers, similarly relied upon different sources to support their economic analyses (see R. 270d–299d). Such reliance was, as mentioned, a matter of necessity, and there is no basis for a contention that it failed to produce rational results.

b. Criticisms of the use of questionnaire data for costing old gas-well gas are without substance

The Commission's findings as to the cost of old gas-well gas are attacked by producer Sun even though they are based on the single Appendix B questionnaire source [80] compiled from the regular books and records of producers who account for 75 percent (R. 309d) of all the gas produced in the Permian Basin and about 85 percent (R. 36e, 1123e) of all the gas-

[80] The old gas-well gas cost study does not depend on a diversity of data sources, such as gave rise to the producers' criticism of the new gas-well gas cost finding. In addition, the Commission "back-trended" the new gas costs to corroborate the old-gas cost which it had derived independently (R. 639d-645d).

well gas produced there. Sun's first criticism is that the Commission's old-gas-cost findings are based on too thin a sample of costs, involving "only about 15.3 percent of the production" in the Permian Basin area. The principal basis for the limitation, however, as Sun itself explained, is simply the Commission's studied selection of gas-well gas as a pricing yardstick.[81] There was no failure to secure representative data on gas-well gas costs in the Permian Basin area.[82] It just happens that most Permian gas is oil-well gas.

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[81] We defend that selection *infra*, pp. 155–160.

[82] To be sure, not all small-producer costs were included, the necessary data being incomplete (n. 78, *supra*, p. 106), but this almost certainly made no difference. There is inconclusive evidence that some costs may be higher for small producers (small producers' drilling costs constitute a higher proportion of their revenues, R. 958e), but there is offsetting evidence as to other components (*e.g.*, geological and geophysical costs, R. 1656, and lease-acquisition costs, R. 1465–1467). Appendix C data showed a cost for reporting producers higher than the average large producer cost, but small producers had an option of reporting on either Appendix B or C and those small producers exercising the former option accounted for about as much gas-well gas as the others. The Appendix B small producers had lower overall costs for gas-well gas than did the large producers, and combining both sets of small producers' cost data for gas-well gas resulted in a difference of only a fraction of a cent (R. 1853–1854, 1116e–1121e). A small producer who had been unable to submit cost data in a usable form for the statistical composite testified that, on the basis of his experience, the unit costs of small producers were no higher than those of large producers (R. 1656–1658). We note that the small producers do not ask that their rates be set on the basis of their allegedly higher costs. They recognize that the rates allowed the major producers establish the practical ceilings on what purchasers will pay.

Sun also criticized the deliberate exclusion, in determining production costs of old gas-well gas, of about 40 percent of that gas—to wit, that produced under combination leases.[83] The Commisison excluded these volumes because analysis of the relevant cost data would have necessitated the making of cost allocations less meaningful than those required for the remaining gas-well gas (R. 810d–812d). In this, the Commission followed the advice of producer witnesses (R. 847e)[84] and rejected that of its own staff (R. 425e, 427e). The staff's evidence indicated that the exclusion of the combination leases had the effect of raising the average cost of gas-well gas (see R. 427e). Sun, therefore, has no basis for complaint.

Apart from its claims as to omission of data,[85] Sun argued that the composite cost data upon which the

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[83] A combination lease is one that permits production from both a gas reservoir and an oil reservoir.

[84] The new-gas witnesses similarly excluded combination leases in some of their computations.

[85] Sun complained of these further omissions from the cost study: (1) the production cost data collected by the Appendix C questionnaire, (2) the results of the Appendix B questionnaire sent to the Hunt Oil Company, and (3) the failure to secure such data from El Paso Natural Gas Company. These omissions are trivial. The Appendix C data related to only 3 percent of the gas-well gas produced in the area, and its impact on the entire cost study was less than one mill (R. 630d). The single Appendix B questionnaire excluded from the staff exhibits (on the ground of noncompliance with the reporting instructions) was publicly available for many months during the hearings, and continues to be so; yet Sun has never suggested that adding the data from this single questionnaire to the composite would have materially changed the result. El Paso's costs were excluded because the Commission sought cost data only from independent producers, and not from integrated pipe-

Commission based its yardstick are unreliable because they include costs from the accounting records of companies that use diverse systems of accounts. This argument has been thoroughly considered (R. 483d–493d, 87d–96d, 1047–1048), and the short answer to it was stated by one of the Commissioners even before the evidentiary hearings began (R. 484d):

> Assembling the cost data received from the many producers has been a difficult but a challenging undertaking. Problems were solved on the basis of the weight and materiality of the variation rather than by attempting to obtain a refinement in the data, such as would be required in an individual company proceeding. [Footnote omitted.]

Prescription of a uniform system of accounts was resisted by Sun and is not a legal prerequisite to area pricing;[86] the agency's judgment—which enjoys

line producers, whose rates were not at issue in the case. Cost data were secured from all corporations owned by El Paso that qualified as independent producers under 18 C.F.R. 154.91(a). The question of the proper regulatory treatment of pipeline production has been set for hearing in a separate proceeding. See 31 F.P.C. 1595; 35 F.P.C. 497.

[86] The California Public Utilities Commission filed a petition on July 9, 1962, requesting that the Commission establish a uniform system of accounts applicable to independent producers of natural gas. Upon consideration of a number of objections—including Sun's—the Commission determined that it would not prescribe such a system until after decision of the first area rate case had indicated what data would be needed. See order issued October 31, 1963, in F.P.C. Docket No. R–220, 30 F.P.C. 1192. Among the reasons which Sun successfully urged for denying California's petition was that uniform accounting was unnecessary and "ignores reality" since the Federal Power

the support or acquiescence of the remaining parties—should not be disturbed for want of such a system.

Nor is there merit to Sun's argument that the cost data obtained from the producers were unreliable hearsay under *Powhatan Mining Co.* v. *Ickes,* 118 F. 2d 105 (C.A. 6), and *Wirtz* v. *Baldor Electric Co.,* 337 F. 2d 518 (C.A. D.C.). Those cases are inapposite. There, the individual responses to the questionnaires had not been fully disclosed to the parties. Here, since the names of the respondents and the contents of their responses were fully disclosed and made a part of the public files, there was ample opportunity to test the probative value of the data submitted.

Sun's final contention is that it demonstrated mathematically that the area costs relied upon by the Commission were unsound and unrepresentative. But all that its witness demonstrated was that the average costs in the test year as determined from the questionnaires diverged from the cost experiences of individual companies that year. And none denies that a particular company's costs will vary from year to year—that is indeed a principal reason for using the group average. Nor did Sun's witness suggest any alternative costing method that would have been superior.

Commission in this Permian Basin case had distributed questionnaires designed to elicit comprehensive cost data with the cooperation of the producers. Sun said: "To provide, in addition, a Uniform System of Accounts, as California insists, would be wholly superfluous * * *".

2. The producer objections to the costing of new gas-well gas are unpersuasive

a. The Commission's determination of the rate base was reasonable

One cost of doing business is the capital cost—the cost of recompensing the invested capital that enables the business to function. In the terminology of public utility regulation, this cost is determined for ratemaking purposes by multiplying the "rate base" (investment) by the percentage rate of return on investment deemed appropriate.We consider here the rate base for new gas-well gas, a rather complicated determination because of the inappositeness of conventional rate-base measurements.

In a traditional utility cost of service, the rate base is easily determined by calculating the net investment devoted in the test year to utility service and adding a reasonable allowance for working capital. Theoretically, that investment might be lower the next year due to depreciation—which would require a recomputation of the rate to reflect a smaller allowance for a return on investment—but ordinarily any such reduction in prior capital investment is offset by new investment, so that the rate base remains relatively stable and the rate need not be computed each year.

The special problem presented here results from the fact that under the Commission's pricing system for new gas-well gas the current costs of finding and producing gas are utilized as the basis of calculating the rate allowed—this to stimulate explorative efforts.

While these costs may increase at some future period, thus justifying increasing the rate for gas found subsequent to such cost change, the change would not justify raising the price for gas found prior to that date, thereby giving the producers a windfall on gas that cost less to find. Thus, to achieve the purpose of the multiprice system adopted by the Commission, it is necessary to treat each "vintage" of gas (or at least a group of similar vintages) separately, with its own rate base and its own price. Since the investment in any discrete production facility or group of facilities will decrease over a period of time, unless there is to be a different price each year for every vintage or group of vintages it is necessary to provide a reasonable and viable mechanism for computing a constant rate for such gas.

The mechanics of the Commission's solution need not detain us long. Instead of a declining rate base, the Commission determined the average investment outstanding at any given time that the gas of a particular vintage is being produced, thus permitting a constant return allowance for each year that the well is producing. For purposes of determining this average the Commission, simplifying a more complex actual production pattern, assumed that a gas well depletes at a uniform rate and is totally depleted at the end of 20 years. Since the producer thus has 20 years in which to recover his capital outlay, and since the Commission found that the annual capital-recovery cost (depletion, depreciation and amortization) was 3.95 cents per Mcf, the Commission concluded

that the total investment required to produce one Mcf a year for twenty years was 79 cents, and that the average investment outstanding at any given point of time was therefore 39.5 cents. Allowing for a time lag of one year between investment and first production, the Commission raised this figure to 43.45 cents. This is the unit rate base for new gas-well gas.

This figure is challenged by the producers, who argue that the Commission should have used a 1960 investment base of at least 79.0 cents per Mcf for new gas-well gas, with a declining return based on a declining rate base. While conceding that over a twenty-year period they would earn the same total return allowance using the 43.45 cents average investment base and receiving a constant return, as they would using a declining investment base starting at 79.0 cents and receiving a declining return, they contend that the twenty year period adopted for pay-out of production investment was too short and that the use of the constant return results in a loss of present worth. Revenues that would otherwise be received now are postponed, and are worth less when finally received because of the time value of money. But the 5 percent depletion rate resulting from the industry's own accounting practice (Tr. 11556) is consistent with the twenty year pay-out adopted by the Commission.[87] And the Commission found (R. 594d–

[87] We note further that the take-or-pay contractual provisions normally incorporated into the producers gas-well gas contracts similarly have as their object assurance of a constant yearly payment to the producer for about 5 percent of the total revenues to be derived from a particular well (R. 1018, 1022–1023).

595d) that while the actual period of production is somewhat longer than 20 years, the rate of depletion is not constant; rather, production usually begins to decline some 7 to 12 years after the well begins to flow, and during its last years the well is producing only a fraction of its flow in earlier years (see R. 778e). Consequently, even though under the Commission's method the return allowance for new gas-well gas found in a given year is constant, the portion of total return actually earned will be greater in the early years for each vintage of gas than in the later years, since, as mentioned, far more than the average annual flow of a given vintage is produced and paid for in the early years of the depletion period.

All this is not merely speculation. The Commission recognized the element of artificiality in the average-investment assumption. But there is empirical evidence demonstrating that in end result the Commission's average-investment, constant-return technique provides a fair method of covering the industry's costs, as well as being administratively convenient. The witness who sponsored the approach adopted by the Commission checked the simplified uniform-depletion assumption against realistic production patterns (R. 1018–1023, 1824, 778e), and found that the unit revenues indicated by the simplified version, appropriately discounted to take into account the complexities of gas production, still allowed full recovery of the expenses, the capitalized investment, and the return thereon, including the time value of money.

Nor did the Commission's rate-base computation slight the need for growth in the finding of reserves.

It was not required, as some producers have contended, to include an allowance for growth in investment (R. 594d). The investment in successful efforts resulting from exploration is capitalized and recovered (with return), over the life of the reserves added, in the rates collected for the gas to be produced. Thus, growth is recompensed as it is produced. An additional allowance in the rate base would be redundant. By contrast, an additional allowance was appropriately included for dry holes and other unsuccessful exploration efforts, which are expensed over current production rather than capitalized over larger future production.

Finally, the producers have argued that the new gas-well gas return fails to take account of the subsequent investments required to replace equipment and maintain production during the period of depletion. The Commission did consider this need for additional investment. In deriving the 0.31 cents per Mcf "Cost of Other Production Facilities," it included an allowance for all investments in lease facilities, including any additional capital investment (*e.g.*, compressors, water disposal operations, etc.) which would be required to fully deplete wells which began producing in prior years (R. 593d, 1426–1428, 776e). And no credit was applied against costs for the 10–15 percent of tangible well and lease equipment investment that is recoverable as salvage (R. 286d).

b. The allowance for the cost of drilling successful wells is reasonable and consistent with the net liquid credit provided

In computing the allowance for the cost of drilling successful wells, the Commission properly used the

national average drilling cost per foot rather than the much higher drilling cost per foot of the respondents to the Commission's questionnaire. None of the witnesses who presented new gas cost studies used the high drilling costs from those responses directly, because there were no data on the reserves added by that drilling. (The respondents had persuaded the Commission not to require reports of their reserve data (R. 38d, 47d).) Reserves-added data were available only aggregately for all producers; accordingly, it was appropriate to use industry-wide drilling data. Thus the suggestion of one producer that the use of overall drilling costs prejudiced those having allegedly higher costs (due to deeper drilling) was properly rejected, the reserves-added data relating to those higher drilling costs having been withheld at the producers' request. In addition, deeper drilling may well result in larger reserves added, so that the unit cost per Mcf of reserves found may actually be less for deep drilling even if the per-foot or per-well cost of drilling is higher.

In determining the net liquid credit,[88] there was no similar objection to using data contained in responses to the Commission's questionnaire. Calculation of a unit credit requires information as to the volume of gas production and the condensate revenues received for such production, and the responses to Appendix B of the questionnaire furnished both sets of data. Data of the questionnaire respondents were viewed as

[88] The credit for valuable liquid hydrocarbons, or condensates, extracted from the gas.

especially suitable for estimating the condensate credit that might be anticipated over the life of the new gas-well gas being priced. The respondents' past drilling and present production both yield substantial condensate; likewise, present industry drilling and new gas in general yield substantial condensate. But national figures which include old gas are less indicative of the condensate yield of new gas because those production data include substantial production from old, dry gas fields, such as the Hugoton Field. In short, the figures derived from the 1960 responses to the questionnaire were properly considered more nearly representative of current new-gas condensate trends than industry production data. Yet, even these responses may be conservative in view of the upward trend since that time.[89]

c. The lease-acquisition allowance is also reasonable

The producers argue that in determining the lease-acquisition allowance[90] in the new gas-well gas rate, the Commission should have used the 1960 ratio of lease-acquisition outlays to successful-well outlays, or, alternatively, a trend of such ratios for the years 1957–1960, instead of the average ratio for the latter period. The argument is without merit. The use of

[89] Moreover, in arriving at the credit the Commission discounted the 1960 figures to take account of producers' criticisms (R. 389d).

[90] This was based on the weighted average ratio of annual lease-acquisition costs to annual well-drilling costs for the years 1957–1960. The ratio (found to be 26.4 percent (R. 281d)) was multiplied by the allowance for successful-well costs to yield the lease-acquisition allowance.

lease-acquisition cost data for a single year was rejected by key witnesses (R. 1013–1014, 991) because such outlays vary considerably from year to year, being significantly influenced by federal offshore lease sales at which blocks are offered at irregular intervals.[91] And no upward trend in the relationship of lease-acquisition outlays to successful-well outlays was found (R. 1742, 281d, 804d, 805d).

The producers also complain that the lease-acquisition allowance is deficient because it makes no provision for "lease abandonments". Since this point was not raised in the applications for rehearing before the Commission, it may not be urged here (see n. 34, *supra,* pp. 56–57). At all events, the Commission did cover lease abandonments; it included amortization of all lease-acquisition costs in the allowance (R. 803d–808d) whether the acquired lease was productive or later abandoned. In addition, the Commission capitalized all lease-acquisition expenditures, thus allowing even abandoned leases the full return enjoyed by successful leases.

3. *The Commission properly costed old gas-well gas*

As noted earlier, the Commission determined the costs of old gas-well gas separately from those of new gas-well gas. We show here that its old-gas-well gas cost determinations were proper.[92] The principal ob-

[91] The examiner and the Commission found also that in 1960 there had been unusually large sales of offshore leases, which made that year non-representative (R. 282d, 806d).

[92] No determinations were made of oil-well-gas costs (see *infra,* pp. 155–160).

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jections to these determinations concern the vexing problem of allocating joint costs of oil and gas exploration and production, and so it is appropriate to note at the outset that the Commission checked the results of its allocation methods against the results yielded by entirely different methods: Having developed the test-year production cost of old gas-well gas by the methods here contested, the Commission then derived approximately the same cost figure by deflating or back-trending its new gas-well gas cost, which had been determined by other methods (R. 639d–645d).

a. The Commission's allocation of exploration and development costs to old gas-well gas, using the modified Btu method, was reasonable

Old gas-well gas is a by-product of the search for oil, and this creates difficult costing problems. If a producer drills a dry well, or acquires a lease but has yet to drill, by what formula should his expenditures be allocated between oil and gas, when neither has been found? The Commission's answer was the "modified Btu" method, one it has previously used to allocate costs of exploration and development. *Phillips Petroleum Co.*, 24 F.P.C. 537, 555–560; *Continental Oil Co.*, 27 F.P.C. 96, 104; *Hunt Oil Co.*, 28 F.P.C. 623, 624; *H. L. Hunt*, 28 F.P.C. 897, 901, vacated on other grounds *sub nom. Hill* v. *Federal Power Commission*, 335 F. 2d 355 (C.A. 5). We urge that it is a reasonable method which should, therefore, be sustained.

The essence of the method is to allocate joint costs in proportion to the relative energy content (Btu's) of the oil and gas yielded by productive wells, in recognition that the principal value of both products is as a fuel, but then to modify this strict Btu allocation in recognition of additional economic factors relevant to a proper equation of these fuels. Oil and gas differ not only in energy content but in end use, demand, and other respects.

The precise formula applied by the Commission in the instant proceeding (see R. 634d–638d) may be expressed as follows:

$$\text{1960 gas e \& d}^{\text{as}} = \frac{\text{total Btu's of gas-well gas produced in 1960}}{3.5 \times \text{total Btu's of oil (and other liquids) produced that year} + 1.0 \times \text{total Btu's of all gas produced that year}} \times \text{total 1960 oil and gas e \& d}$$

In other words, the Btu contents of oil were weighted by a factor of 3.5 (rather than a factor of 4.0, as used previously in individual producer cases). In making this adjustment, the Commission noted, among other things, that the production cost of a Btu of oil is roughly 4.5 times that of a Btu of gas; that the price of gas has moved sharply upward in relation to the price of crude oil; and that it was determining a cost to be used for fixing prices for flowing gas for the future, as well as for the past (R. 634d–638d; see, also, R. 808–835, 458e–484e).

Exploration and development costs could be viewed as an overhead of the oil and gas production business, somewhat analogous to research and development expenditures in other businesses (R. 704–706). Since overhead costs are frequently allocated in proportion to direct costs (*e.g.*, 813d), exploration and development costs here could have been allocated ex-

[as] That is, total exploration and development costs to be allocated to gas-well gas in 1960, the test year.

clusively according to the relative production cost of gas and oil. The Commission noted, however, that producers' exploratory efforts go beyond merely maintaining the existing level of gas production (as reflected in the steady growth of gas production over the years) and that the product "mix" has been shifting toward gas. Accordingly, it tempered the relative production cost ratio of 4.5 with the other relevant economic considerations to arrive at an appropriate allocation factor.

The producers' principal criticism of the modified Btu method is that it is circular—prices are used to determine costs which are then used as a basis for determining those very prices. The supposed circularity concerns only one of the many factors used by the Commission in deriving the proper economic factors—the relationship between the price for a barrel of liquids ($2.90) and the price for an Mcf of gas (16.5¢)—and even here the Commission avoided circularity by using prices that were completely independent from the costing of old gas-well gas.[94] Thus, the claim of circularity is at bottom a suggestion that relative value is an inappropriate guide to allocation because it involves prices. We know of no basis for this blanket disparagement, and note that the rela-

[94] The $2.90 per barrel price for liquids is the national market price and is not affected by, or subject to the control of, the Federal Power Commission. The 16.5¢ price is the price that the producers will be allowed for sales of new gas-well gas. This price, though set by the Commission, was derived in a manner completely independent from the costing of flowing gas.

tive-value method of allocation has been specifically approved. *Colorado Interstate Gas Co.* v. *Federal Power Commission,* 209 F. 2d 717, 726–727 (C.A. 10), reversed on other grounds, 348 U.S. 492; see 11 F.P.C. at 344–346.

The producers also attack the Commission's allocation of exploration and development expenses for old gas by pointing to two studies which, they argue, demonstrate an inconsistency in the methods used by the Commission in determining the old and new gas exploration and development allowances.

The first study was reasonably rejected by the Commission as lacking in probative value (R. 636d). As the Commission pointed out, the dry-hole cost calculation was based on a subjective declaration of intent by a non-random sample of producers with a considerable degree of self-selection in the sample; and the allocation between gas and related condensate ignored, and indeed contradicted, important economic considerations.[95]

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[95] The study (R. 846e, 837e–838e) developed the exploration and development allowance in the following manner. First, costs were allocated between gas reservoirs and oil reservoirs. Developmental dry-hole costs were allocated by the proportions derived from responses of 26 companies to a questionnaire circulated by Phillips Petroleum Company, which attempted to trace costs to the gas reservoir on the developmental leases. (Interestingly, this step was not suggested by any witness who prepared a new gas-well gas exploration and development allowance.) Exploratory dry-hole costs (including test-well contributions) were allocated between gas reservoirs and oil reservoirs on the basis of intangible drilling costs of successful oil and gas exploratory wells drilled by respondents during the period 1956 through 1960. A similar method had earlier

In its application for rehearing, Perry R. Bass, *et al.*, presented a new study purporting to compute the old gas-well gas exploration and development allowance (R. 1079d–1085d, Exh. 1 to the Application for Rehearing). This belated presentation—which is quite similar to the first study rejected by the Commission—is justified by its protagonists on the ground that it conforms to the new-gas costing methods adopted by the Commission. In fact it does not.

The rehearing study uses 1960 drilling costs to allocate the total test-year exploration and development costs; it then spreads the amount allocated to

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been considered and rejected in *Phillips Petroleum Co.*, 24 F.P.C. at 664 (examiner's decision).

All other exploration and development costs, except exploration and development overhead, were allocated between gas leases and all other leases on the basis of equipping and intangible drilling costs of total successful oil and gas exploratory and development wells drilled by respondents in 1956–60. The bulk of the exploratory and development costs fall into the "other" category, which comprises well over $1 billion (including return on leaseholds held for future exploration). These costs mainly concern acquisition of land rights and geological and geophysical information, matters which are quite distinct from drilling costs. There was no demonstration that these "other" costs should logically follow the relationship between oil and gas well costs. Overhead costs were allocated on the basis of the percentage of exploration and development costs which had already been allocated to gas. Having determined what costs were allocable to the gas-well gas reservoirs, the witness then allocated the costs between the gas and condensate on the basis of the "vapor volume method", which allocated about 99 percent of the cost to gas. Since these methods, unlike the methods adopted by the Commission, ignore the economic objective of exploration and development, namely the finding of new underground reserves of oil and gas (an inventory process), the Commission quite properly did not rely upon them.

gas reservoirs over 1960 gas-well gas production. That is quite different from the Commission's new gas-well gas costing methods, which are methods for estimating future costs, not merely methods for allocating test-year expenditures (R. 1555–1557, 1417, 1423).

First. In costing new gas-well gas, the Commission determined the expectable dry-hole and other exploratory expenditures per Mcf found, not per test-year Mcf produced. The old-gas study cannot duplicate the new-gas methods because the trends in reserves found or added by the Permian respondents are unknown. (The Commission honored producers' requests that these reserve data be withheld as confidential (R. 38d, 47d).) In its new-gas costing the Commission adjusted these new-gas exploration and development allowances to a projected production basis, reflecting the expectable relation between findings and production. But there is no way of telling whether the cost-of-service test-year gas production is the appropriate volume for the costs estimated in the Bass rehearing study or bears an expectable relation to the unknown reserves relatable to those costs.[96]

Second. In costing new gas, the Commission and witness Roseman were careful to evaluate data in the light of trends; they did not just assert and rely on a single year's data (*e.g.*, R. 766e–790e, 579d–584d). Similarly, with regard to old gas, the *total* exploration and development costs in the 1960 test-year were

[96] If test-year production volumes (not reserves found) were properly employable, the rehearing study should at least have included reinjected volumes, which it excluded (compare R. 824d and related text at R. 814d–815d).

shown to be typical for recent years (R. 784); and the Commission allocated that total exploration and development cost in terms of production trends, etc. (R. 634d–639d). The 1960 allocation data relied on in the Bass study do not appear to be typical, for they exaggerate the amounts allocable to gas compared to data embracing a period of recent years (cf. R. 604e–606e, 1467).[97]

Third. The rehearing study is wholly incompatible with the Commission's treatment of lease-acquisition costs in its new-gas analysis. The Commission evaluated the contemporaneous lease-acquisition expenditures per Mcf found, capitalized them, depleted them over the life of the reserves currently added, and also allowed a related return for that period. The rehearing study, however, takes past lease expenditures (the costliest single exploration and development item included in the old gas cost) and allocates these past expenditures between gas and oil according to current drilling ratios. It does this even though there is no reason to assume that the incurrence of these *past* expenditures for unsuccessful or untested leases can reasonably be related to *current* successful drilling costs.[98]

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[97] While the Bass study relies on 1960 data only, the producer's own witness had previously relied on the data for at least 1956–1960 (R. 839e). See, also, R. 1467.

[98] In addition, the Bass study, while purporting to allocate costs of the gas-well gas leases between condensate and the gas by crediting liquid revenues, did not include any amount for the leases' share of the processing plants' liquid revenues, an item considered in the new gas costing. We discuss this point more fully with respect to the propriety of the Commission's allocation of production expenses, *infra*, p. 130.

These considerations make clear that, contrary to the producers' assertions, the Bass rehearing study does not show what the old gas costs would be if allocations had been performed identically to those used in the Commission's new gas cost calculation (R. 1079d). Accordingly, the study in no way supports the claimed inconsistency between the modified Btu allocation method and the allocation method implicit in the new gas-well gas costing [99] or the claim that the different methods were arbitrarily adopted by the Commission to obtain low cost results. Moreover, not only did the witness sponsoring the new gas-well gas allocation method explain the compatibility of the two approaches, but the available data prevented employment of the same method for the two different costing approaches (R. 1803–1806). Finally, the trend-back method reconciles the new gas and old gas methods; it shows that the new gas cost, when appropriately deflated, approximates the result derived by the old gas costing methods (R. 639d–645d).

b. The Commission's determination of the costs of producing old gas-well gas was also reasonable

Producers have contended that the Commission made a number of errors in determining the production costs for old gas-well gas. These contentions are unfounded.

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[99] With few exceptions, the new gas-well gas costing did not explicitly allocate between oil and gas. It directly estimated the appropriate cost level for new gas-well gas, but did not thereby necessarily measure an associated estimated cost of new crude oil; the old gas costing, based on allocation of past expenditures, necessarily determines test-year oil costs for most cost components.

(1) *The Commission's choice and application of the relative-cost method of allocation were proper.*— The old gas-well gas costed in this case included not only dry gas, but also gas produced from gas condensate reservoirs. Accordingly, while the major portion of the production costs could be assigned directly to the gas leases, it was necessary to allocate costs between the liquids and gas produced from gas condensate reservoirs where the liquids were separated on the lease. The so-called relative-cost method was used by the Commission for this purpose (R. 748–749, 786–808, 423e–441e).

The theory of the relative cost method is that when allocating costs between two products produced under joint conditions, it is reasonable to allocate the joint costs in proportion to the relative cost of producing the products separately. Accordingly, producers' actual joint production costs were apportioned here on the basis of the ratio of the cost of a barrel of oil produced in the virtual absence of gas to the cost of an Mcf of gas produced in the virtual absence of liquids.

First, the unit costs of oil from leases producing oil only ("oil leg") and of gas from leases producing gas only ("gas leg") are determined. The unit cost of producing gas from gas-only leases is multiplied by the number of units of gas produced from joint-product leases, and the unit cost of oil from oil-only leases is multiplied by the number of units of oil produced from those joint-product leases. The two figures derived state, in effect, what gas and liquids from the joint-product leases would have cost had they

been produced from single-product leases. The two dollar amounts make it possible to compute the ratio of the total costs that would have been incurred in producing gas if all the gas had come from gas-only leases. Using ratios determined in this manner, the gas proportion of the total actual production costs is then assigned to gas (R. 631d–633d).

Producers criticize the use of the method by pointing out—as none disputes—that condensate liquids cannot be produced separately from gas. However, since condensate liquids are a light oil largely interchangeable with crude oil (see *Phillips Petroleum Co.*, 24 F.P.C. 537, 559), the cost of producing oil only may fairly be regarded as the economic cost for condensate. Moreover, the market value of an Mcf of gas or a barrel of oil or liquid condensate is not affected by whether it is found alone or as a joint product. In these circumstances, the Commission was reasonable in allocating the production costs of gas and condensates on the theory that each product should bear costs in relationship to the costs the producer would be willing to incur to produce the products separately. As the Commission also observed (R. 632d), the relative cost method "is relatively simple and workable, has been accepted in principle in our electric power work for decades, and has been repeatedly used and approved by the Commission in producer rate cases." See *Phillips Petroleum Co.*, 24 F.P.C. 537, 555; *Hunt Oil Co.*, 28 F.P.C. 897, vacated on other grounds *sub nom. Hill* v. *Federal Power Commission*, 335 F. 2d 355 (C.A. 5); *Union Producing Co.*, 31 F.P.C. 41, 48.

The producers contend further that the Commission's use of the relative-cost allocation for costing old gas was inconsistent with use of a liquid-credit allocation to cost new gas, and that the relative-cost method was adopted solely to obtain a lower allowance. But the record did not contain sufficient evidence to permit a liquid-credit computation for old gas-well gas. Although the Commission could have determined a credit from revenues derived from liquids extracted at the lease, there was *no* evidence presented by any party as to the revenues the producers had received in the past from the sale (by either processing-plant operators or pipeline buyers) of liquids extracted from the gas stream sold.[1]

While they assert that, had the Commission used the same allocation methods for old gas as for new gas, the old-gas costs would have been substantially higher than the area rates fixed by the Commission, the producers do not attempt to estimate the effect of crediting liquid revenues in lieu of allocation by means of the relative-cost method. Since the liquid credit is not accurately known, a precise comparison is obviously impossible. But our calculations indicate that the re-

[1] Producers' old gas cost computations, which are attached to Bass' application for rehearing (R. 1079d–1085d), used a liquid credit of 2.93 cents per Mcf derived solely from the revenues related to the Permian Basin area leases designated as gas condensate with lease separation, but included no plant liquid credit (R. 1081d, 1084d). Revenues to the lease from plant liquids were reported to the Commission as part of the gas revenues and were so reflected in the exhibits.

In costing new gas on a national basis such a credit was included at a stipulated amount (R. 589d–590d).

sults would not have been materially different if a crediting approach had been used.[2]

Petitioners also object to some detailed applications of the relative cost method, including the Commission's use of gross rather than net investment in deriving the oil and gas leg return components. The producers argue that the Commission should have used relative net investment because the joint-product return is calculated on joint-net investment. That is irrelevant. The compelling reason for using relative gross investment is that oil-only leases are generally more depleted than dry gas leases.[3] Use of net invest-

[2] The area production cost as estimated by the producers was 11.62 cents per Mcf, before allocation to liquids; the exploration and development expenditures attributed by the Commission to the three gas-type leases used to cost old gas amounted to $187,962,319, which equals about 4.95 cents if the total is attributed to the related 3,804,646,611 Mcf of gas and not at all to liquids (R. 824d); all that plus 0.14 cent for regulatory expense amounts to about 16.71 cents before allocation to liquids and before production taxes. The liquid credit should be more than the 2.93 cents for lease condensate which producers would have allowed. El Paso's application for rehearing suggests the plant credit might range from 0.6 to 0.8 cent per Mcf (R. 1099d, 1114d). However, ignoring the plant credit for a moment, 16.71 cents less 2.93 cents leaves 13.78 cents plus a 7 percent production tax, or a total of 14.8 cents before whatever more should be deducted for plant credit. Plainly the "liquid credit" approach does not contradict the Commission's determination of 14.5 cents as the just and reasonable rate for old gas-well gas.

[3] Oil leases average 62 percent depletion nationally and 55 percent depletion in the Permian Basin. This is in contrast to an average depletion for gas-only leases of 40 percent nationally and 37 percent in the Permian Basin (R. 794, 821d). The gas condensate leases average 36 percent depletion nationally and 25 percent depletion in the Permian Basin (computed from R. 421e).

ment would tend to assign less cost to oil and more to gas because of the difference in relative state of depletion, even though neither matches the state of depletion on joint-product leases. Allocation on the basis of the gross investment avoids this incongruity (R. 821d–822d).[4]

In computing the gas and oil legs, the Commission declined to include shut-in leases. The producers contended that shut-in leases should be included in determining the allocation percentages because they are part of the cost of producing gas and oil. But shut-in lease costs are not representative of the production costs of either gas wells or oil wells; such leases are essentially non-producers. An allocation method which defines the allocation ratio as the relationship between liquid and gas unit costs should not include costs where there is no corresponding volume to be employed. The Commission reasonably concluded that their inclusion in the oil and gas legs would distort an otherwise representative single-product cost factor and thus defeat the underlying principle of the relative-cost allocation method (R. 790–793, 820d).

Finally, producers have argued that in determining the unit cost applicable to the gas leg the Commission should have used not only gas-only leases but also the costs from the gas condensate leases. The purpose of the relative cost method of allocation, however, is to derive the cost of producing gas separately and the Commission reasonably decided that

[4] The Commission might have allocated on the basis of unit capital recovery charges; and that would have attributed less to gas than the method it used (R. 795–796).

the representative costs for this purpose are those under the gas-only leases, unless such leases provide too small a sample, and that here the gas-only leases composed a representative gas leg.

(2) *The Commission did not include non-salable carbon dioxide in the volume of gas used to compute the production-cost allowance.*—It has been argued by Skelly Oil Company that the Commission understated the unit cost of old gas-well gas by 1.6 cents per Mcf by including in the production volumes a large amount of non-salable carbon dioxide.[5] This is inaccurate. Skelly's volume figures derive, not from the Permian questionnaire, but from either Exhibit 118 (R. 275e–291e) or 1960 Form 301B reports (forms annually filed with the Commission), and both of these sources include volumes attributable to royalty interests as well as the seller's interest.[6] By contrast, the questionnaire responses reflect the smaller volumes, exclusive of royalty, relevant for purposes of spreading the producers' total costs over only their own volumes (R. 53d).

Detailed instructions accompanying the 1960 Permian questionnaire called for the reporting of gas, not non-salable or non-usable carbon dioxide (R. 49d–

[5] The Commission's calculation of the old gas-well gas production cost per Mcf was made by first determining the total applicable production costs of the producers filing Appendix B responses (*i.e.*, $19,096,630) and then dividing that sum by the volume of gas-well gas related to such expenditures (*i.e.*, 208,486,740 Mcf). The result is the 9.16 cents per Mcf production cost allowed in the area rate.

[6] The royalties are, in effect, included as a cost to the operator.

52d). The very purpose of the questionnaire, which was isued and answered only after review and modification by the producing industry, was to obtain the cost of natural gas, not the cost of carbon dioxide, with each schedule of the questionnaire aimed at obtaining data for this purpose. Indeed, Schedule K, subsection 6 of "II—Volumes—Net Working Interest Production" (R. 51d) specifically instructed producers that if their production volumes included any amount to which there could not be attached any revenue or transfer value, then such volumes should be identified in the analysis of the volumes of production. Producers did not note any such volumes of carbon dioxide to which there was not attached revenue or transfer value. Certainly, if they had included the nonsalable, useless carbon dioxide volumes, they would have noted as much in their responses.[7] The instructions to Schedule K, subsection 2 of "III—Analysis of Net Working Interest Gas Volumes Produced" (R. 52d) also show that the producers were to report production volumes which represented the volume of

[7] With respect to two rate schedules relied upon (Rate Schedule No. 192 of Gulf Oil Corporation and Rate Schedule No. 30 of Standard Oil Company of Texas) there exists the possibility that the Schedule K production volumes could have included some carbon dioxide volumes. This is possible since under these two rate schedules the producers appear to be paid for well-head volumes and not volumes remaining after processing as is true under the other rate schedules. Nevertheless, since they are being paid for this full volume, inclusive of carbon dioxide, the producers' argument that the costs will not be recouped from the volumes sold does not apply.

gas "sold, transferred, consumed or otherwise put to *useful* purposes" (emphasis added). Since the producers themselves argue so strongly that carbon dioxide is useless, they certainly would not have reported it as useful.

Throughout the proceeding, all of the experts, including the witness who sponsored the producers' old gas cost presentation, applied and employed the Schedule K production volumes—the volumes now challenged.[8] And reliance on these volumes throughout the hearings and briefing stage without any challenge on the basis of alleged inclusion of carbon dioxide is particularly significant because all through the hearings the producers manifested close interest in what production volumes should bear costs and what reported volumes should be eliminated. Finally, the carbon dioxide issue (injected at the eleventh hour) would appear to be largely mooted by the Commission's supplementary opinion, which permits pro-

[8] Witness Fisher, who developed the staff old-gas cost, considered the 208,486,740 Mcf of production volumes reported on Schedule K as being usable and available for sale (see R. 429e). Witness Keene, whose testimony was sponsored by the "producer group" (R. 1182) which generally included, *inter alia*, Phillips, Atlantic, Standard Oil of Texas, Gulf, and Socony Mobil (*e.g.*, R. 136–138), the companies producing gas together with large volumes of carbon dioxide, reached the same conclusion in Exhs. 243 and 244. Witness Keene combined the reported gas-well gas production volumes of the Appendix B and Appendix C producers in this and his other exhibits. The Appendix B gas-well gas volumes of 208,486,740 Mcf included in Exh. 243, Schedule 1, line 29 (R. 843e), are derived from lines 14 and 18, columns (d), (e) and (f) of that exhibit (R. 842e–843e).

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ducers to price their gas on the basis of the volumes, including carbon dioxide, actually delivered to the pipeline (R. 1108d–1109d).

c. The Commission's treatment of reinjected volumes and overhead expenses was reasonable

The producers have claimed that the Commission failed to consider their arguments against spreading exploration and development and depreciation, depletion and amortization costs over the volumes of gas produced but subsequently reinjected into the reservoirs to improve the well operation and increase the recovery of liquids. The Commission did, however, specifically explain why such costs—as well as all other costs[9]—should be spread over total production volumes—including reinjected volumes—in determining the cost of service for old gas (R. 814d–815d).

The producers have also challenged the Commission's method of allocating overhead expenses and investments. Their arguments were fully answered by the Commission (R. 813d–814d):

> The examiner adopted staff's methods of allocation, and we affirm the examiner's finding. First, as to the issue whether the overhead expenses should be spread over all of the direct expenses including DD&A, it is clear that they should not. Overhead expenses are largely supervisory expenses and have no bearing on DD&A, which are bookkeeping entries to reflect the use of the investment. They should be allo-

[9] The producers have at all times conceded the reasonableness of spreading out-of-pocket expenses and overhead over such reinjected volumes (R. 385d).

cated on the basis of direct expenses being supervised, which are exclusive of DD&A.

The second question is whether to use gross or net investment as the basis for allocating capital items and materials and supplies, two of the items in the overhead category. In allocating the common investment items, gross investment more closely reflects management supervision than net investment which is affected by the amount of gas or oil already produced. The same is true for materials and supplies because such expenses continue regardless of whether the investment has been reduced by depreciation and depletion. * * *

4. Other objections relating to costing of both old and new gas are also without merit

a. The Commission reasonably declined to include a federal income tax allowance in its costing of new and old gas

The producers have challenged the Commission's finding that there is no probative evidence in the record that federal income taxes are paid by producers on revenue derived from natural gas production, and its reliance on testimony by a staff witness (*e.g.*, R. 1825–1826) that there would be no income tax liability at any return up to 15 percent (R. 612d, 300d). The producers rely on a study, based upon Internal Revenue Service data, which purports to show that one group of producers paid approximately 8.5 percent of corporate gross revenues as taxes during the years 1956–1959. However, evidence presented by a witness from the Internal Revenue Service, and cross-examination of producers' witnesses, indicated that the study was defective. Its

data were for a group of producers that did not include the major oil companies (classified as refiners, R. 1388–1390). And roughly half of the relevant tax returns filed by independent producers were excluded solely because balance sheets were not included with the filing (compare R. 11s with R. 1035e–1036e and R. 1038e–1045e). Thus, the study related to only a small fraction of the total gas production. Moreover, the 8.5-percent figure merely stated theoretical taxes computed on the basis of the income reported in the return (including foreign income), prior to allowances for tax credits, including foreign tax credits (R. 1391). When the foreign tax credits alone are taken into account, they virtually eliminate the tax liability. Finally, the revenue reported in the Internal Revenue Service filings included those derived from secondary businesses, many unrelated to oil or gas production (R. 1388, 1035e–1036e, 1038e–1045e).

The producers cite the testimony of the distributors' witness Roseman that there would be a tax of 0.6 cents per Mcf if the rate of return was 12 percent. But this was purely a mathematical calculation that the witness himself qualified by stating that many major producing companies in the past had been found to pay no income taxes and that there was no evidence that taxes were in fact being paid by the independent gas producers (R. 1042–1045, 612d). At all events, under the Commission's ceilings, gas production is expected to earn less than 12 percent overall (see *infra*, p. 141). Moreover, Mr. Roseman's computations, in estimating the tax deduction for intangible drilling costs of gas wells, gave no weight

to the predicted growth of gas exploration and development (compare R. 1043 and 1044–1045 with R. 1032).

b. The Commission determined a reasonable working-capital allowance

The Commission allowed a return on a working-capital allowance equal to (1) one-eighth of the producers' annual production, operating and exploration expenses, and (2) the amounts invested by them in supplies, materials and pre-payments relating to exploration and production (R. 1023–1024, 607d–610d). This is the formula consistently employed by the Commission in producer cases. *Phillips Petroleum Co.*, 24 F.P.C. 537, 566; *Hunt Oil Co.*, 28 F.P.C. 623, 625; *Union Producing Co.*, 31 F.P.C. 41, 49. In addition, the Commission allowed in the new gas-well gas rate a return on liquid sums held for purchasing leases.[10]

The producers' argument for a greater working-capital allowance is based on a "balance sheet" formula which, the Commission explained (R. 607d–608d), contains the very flaws which caused the rejection of similar proposals in prior cases. *Cities Service Gas Co.*, 3 F.P.C. 459, 478, affirmed, 155 F. 2d 694 (C.A. 10), certiorari denied, 329 U.S. 773; *Northern Natural Gas Co.*, 11 F.P.C. 123, 131, affirmed *sub nom. State Corporation Commission of Kansas* v. *Federal Power Commission*, 206 F. 2d 690 (C.A. 8), certiorari denied, 346 U.S. 922; *Panhandle Eastern*

[10] In view of the use of a year-end rate base, such an additional allowance was found to be unwarranted for old gas (R. 822d).

Pipe Line Co., 13 F.P.C. 53, reversed on other grounds *sub nom. City of Detroit* v. *Federal Power Commission*, 230 F. 2d 810 (C.A.D.C.), certiorari denied, 352 U.S. 829. Moreover, the balance sheets on which the producers rely here reflect substantial amounts of working capital related to marketing and refining, rather than producing, gas (R. 608d).

B. THE 12-PERCENT RATE OF RETURN FOR PIPELINE QUALITY GAS IS SUFFICIENT AND SHOULD BE SUSTAINED

One of the items reimbursed by the area rate fixed in this proceeding is an allowance for a fair return on the capital invested in producing the gas; as has already been noted, this return was determined by multiplying the unit investment by a percentage representing the fair rate of return. The propriety of that rate is in issue here.

1. The Commission concluded that a 12-percent overall rate of return for gas of pipeline quality was appropriate; that it would protect "gas consumers against excessive prices," yet be sufficient "to respond to the needs of the industry" (R. 606d). At the outset of discussion, we stress that the 12-percent rate fixed by the Commission was never expected or intended to denote the average return that would be earned by sales of gas-well [11] gas in the Permian Basin. The rate was deliberately set at a high figure to take account of the substantial risk in the Permian area of finding gas that does not meet pipeline quality standards (R. 602d, 614d, 633d, 1112d). The Commission found that the average cost to the pipelines of bringing Permian

[11] No separate return was computed for oil-well gas (*infra*, pp. 155–160).

gas up to pipeline quality would be between .7 to 1.5 cents per Mcf (R. 1115d)[12] and that this cost should be borne by the producer as a discount from the ceiling price fixed for pipeline quality gas. Translated into terms of rate of return,[13] and ascribing the greater deductions to old gas (R. 633d), this meant that the prescribed area rates might yield as little as about 10¾ percent overall (about 12 percent on equity) on average quality new gas-well gas, and possibly only slightly more than 9 percent overall (about 10 percent on equity) on the average quality of old gas-well gas. These predictions, incidentally, are confirmed by the quality statements filed in response to the Commission's request in its opinion.[14]

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[12] No more precise determination was possible in the state of the record.

[13] The rates prescribed by the Commission reflect royalty and production tax payments the amount of which depends on the actual rate, not the ceiling. If the rate is less than the ceiling because of quality deductions, the cost attributable to royalties and production taxes is reduced by about 20 percent of the quality deduction, while the remainder reduces the amount available for return. Thus, for every 1 cent quality reduction, the return allowance would be reduced by only about 0.8 cents.

[14] These quality statements show that the average quality impact, based on the 1960 volumes, is .78 cents per Mcf for old gas-well gas and .86 cents per Mcf for residue gas. See *supra*, p. 18. The quality impact for new gas-well gas, based on actual or estimated volumes for 1965, has been determined to be .68 cents per Mcf. Since new gas-well gas sales by definition postdate 1960, it was not possible to use 1960 delivery volumes from the record in calculating this quality impact. The calculation relates to about 285 million Mcf of gas-well gas deliveries or authorized deliveries, including residue gas derived from new gas-well gas. The quality impact is not necessarily constant. For old gas the proportions of the gas deliveries under relevant contracts may change, while for new gas-well gas addi-

These findings show that the court of appeals erred in concluding that it could not determine the adequacy of the 12-percent rate of return because the Commission had failed to determine the impact of the quality deductions on the producers' revenues. The Commission accurately estimated that the effect of quality discounts would be to discount the area rate by 0.7 to 1.5 cents. From this it was readily determinable that the producers (contract limitations aside, see pp. 92–96, *supra*) would obtain an average unit yield of about 15.8 cents for average quality new gas-well gas, rather than the 16.43-cent unit cost found for pipeline quality gas-well gas (which for rate purposes was rounded off to 16.5 cents), and as little as 13 cents per Mcf for average quality old gas-well gas rather than the 14.39-cent per Mcf unit cost found for pipeline quality gas. The court below completely overlooked the Commission's findings on this point.[15]

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tional sales are constantly being added. We note that the new gas impact estimated at the time of the Commission's court of appeals brief on the basis of earlier sales was about .3 cents per Mcf.

[15] The producers have claimed that since the exact extent of the specific quality deductions required under the Commission's order was not known at the time of decision, the Commission's estimate of quality deduction is not supported. This is not so. While the pipeline's processing costs were not in the record and a precise deduction for each sale could not be determined prior to further filings, extensive evidence with respect to comparable producer plant processing costs was in the record, together with data showing the quality of much of the gas (R. 254e–293e, 856e–889e). In addition, a number of expert witnesses, utilizing such data, as well as previously agreed-to contract allowances with respect to quality deficiencies, stated their opinions as to

The lower court also faulted the Commission for treating the possibility of finding gas of less than pipeline quality, which the buyer would have to process to bring up to par, as a risk to be considered in determining the rate of return, rather than as a cost. However, it is the return element in a rate that is intended to reflect the degree of risk in making the investment. It was therefore quite appropriate for the Commission to treat the possibility that a significant portion of the gas-well gas sold to the pipelines would be below standard quality, and so require further processing and treating by the pipelines, as an element to be considered in fixing the appropriate rate of return (cf. R. 1402); it is a risk analogous to the risk that a particular well will produce less than the average amount of gas. Moreover, the court's insistence that quality deficiency be treated as a separate *producer* cost overlooks the fact that in the Permian Basin pipelines have bought almost all gas-well gas at the wellhead, with the result that processing costs are typically incurred by the pipeline, not the producer.

To be sure, it might have been possible to set rates for average quality gas and provide a premium for gas of pipeline quality—the "gold standard" technique proposed by the examiner (R. 246d). But in

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the average cost of bringing sub-par gas up to pipeline quality (R. 1724–1731, 1797, 1867–1877). On the basis of their evidence, the examiner, though not defining pipeline quality standards, as the Commission did, concluded that 1 cent represented a reasonable estimate for bringing new gas-well gas up to pipeline quality and 1 to 1.5 cents for old gas-well gas (R. 245d–247d, 257d).

that event a lower rate of return would, of course, have been warranted. Thus, although both the examiner and the Commission arrived at the same 12-percent rate-of-return figure, the examiner concluded that 12 percent was appropriate for gas of the average quality produced in the Permian area, while the Commission expressly held that the 12 percent it was fixing for pipeline quality gas was appropriate only because of the substantial risk of finding gas of lesser quality.

2. The return is adequate. In deeming it appropriate for new gas-well gas, the Commission took as its starting point the rate of return allowed natural gas pipelines. Pipeline operations are, of course, an immediate adjunct of gas production, and the two segments of the industry have evolved contemporaneously. Pipeline rates of return have ranged between 6.25 and 6.5 percent, resulting in an equity return ranging from 10 to 12 percent [16] depending on the pattern of capitalization, *i.e.*, the proportions of debt

[16] Recent equity allowances approved for pipelines have clustered around 10 percent. *Manufacturers Light and Heat Co.*, 23 F.P.C. 446, 448 (10); *Southern Natural Gas Co.*, 24 F.P.C. 26, 30 (10.18); *Tennessee Gas Transmission Co.*, 24 F.P.C. 204, 209 (10.12); *United Gas Pipe Line Co.*, 25 F.P.C. 26, 116 (10.3); *Northern Natural Gas Co.*, 25 F.P.C. 431, 433 (10.5); *Kansas-Nebraska Natural Gas Co.*, 25 F.P.C. 448, 452 (10.8); *Panhandle Eastern Pipe Line Co.*, 25 F.P.C. 550, 551 (10.47); *Alabama Tennessee Natural Gas Co.*, 27 F.P.C. 1180, 1190 (9.5); *American Louisiana Pipe Line Co.*, 28 F.P.C. 482, 485 (9.2); *Midwestern Gas Transmission Co.*, 32 F.P.C. 999, 1000 (9.26); *East Tennessee Natural Gas Co.*, 35 F.P.C. 534, 540–541 (8.53). But see *El Paso Natural Gas Co.*, 28 F.P.C. 688, 701–702 (12–13 percent).

and equity financing.[17] The Commission found that production involves a greater operational risk than transmission, although, not so great an additional risk as the producers claimed. The principal risk—that of finding dry holes—is mitigated by permitting producers to recoup dry-hole and related expenditures in their rates (R. 601d). In addition, there is a degree of predictability as to the industry's ability to make new discoveries and add reserves (R. 602d, 208d–211d). Production remains somewhat more risky than transmission for the individual producers only because of uncertainty whether productivity will meet the industry average and because of the substantial risk (at least in the Permian Basin) that most of the gas found will be below pipeline quality.

In addition to these operational factors, the Commission in fixing the rate of return for new gas-well gas considered extensive evidence (R. 844–936, 541e–

[17] The producers argue that because production involves greater risk than transportation, they are necessarily entitled to earn a higher return on equity than pipelines. Whatever the merits of such an argument with respect to the *overall* returns of the two types of enterprise, the comparison between returns on equity is not apt in view of the entirely different capital structures of producers and pipelines. While 85 percent of the producers' capitalization is common equity, and 15 percent long-term debt, pipelines as a group have had only about 31 percent equity, 8 percent preferred stock, and 60 percent long-term debt (R. 565e, 642e, 599d). The increased risk to the equity holders of having such a heavy fixed debt ratio—which the Commission has expressly recognized in determining the appropriate rate of return for pipelines—offsets the greater operational risk of the stockholders of producers, since they are not burdened with such debt obligations.

565e, 994–1001, 1401–1403, 1406–1416, 608e–701e) of the earnings experience of both producers engaged solely in oil and gas production, and integrated producers, who are also engaged in the refining, processing and distribution of petroleum products.[18] A study of nine companies engaged only in oil and gas production showed for the years 1957–1961 an average return of 12.4 percent (R. 554e). Of these, the seven who produced gas in the Permian Basin had an average return of 13.4 percent (R. 555e).[19] The Commission also found that a group of 26 integrated producers earned an average return of 8.5 percent (R. 554e, 604d). Of these producers 24 produced gas in the Permian Basin area, and they had an average return of 8.3 percent (R. 555e, 604d).

Combining both integrated and non-integrated producers yielded an average return of 9.3–9.5 percent (R. 554e–556e, 605d). The Commission concluded, however, that it should not use these figures directly, because they reflected in large degree the earnings experience of the integrated producers. While those companies dominate the industry, there was insufficient evidence that their company-wide returns (from which the above figures were computed) corresponded to the earnings of their production departments.

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[18] Non-integrated producers account for relatively little of the total gas production (R. 1401, 197d).

[19] Another study, relating to 13 producers also engaged solely in production, showed that for the same five-year period those producers had an average return of 14.5 percent (R. 630e).

For these and other reasons (see R. 597d–606d, 191d–212d), the Commission chose the 12-percent figure for pipeline-quality new gas-well gas. While the considerations were somewhat different, the Commission concluded that a 12-percent rate of return should also be allowed in the cost of service of old gas-well gas, the yardstick for all flowing gas (R. 633d–634d, and *infra,* pp. 155–163). The Commission pointed out that while the risks relating to flowing gas are quite different from those relating to new gas-well gas, the differences tend to be offsetting. Since most flowing gas is not found as a result of a search for gas but rather as an incident to the search for oil, the exploratory risk is properly attributable almost entirely to oil, that being the principal motive for the investment. Consequently, while the finding of gas is doubtless an added incentive, the danger of failing to find it is hardly so serious a risk—if, indeed, it is a risk at all—as the danger of not finding gas when that is what the producer is principally searching for. On the other hand, quality deficiency is not only a more pronounced problem with respect to flowing than new gas-well gas (R. 633d), but the revenues from flowing gas may affect the scale of exploration for new gas-well gas (see *supra,* pp. 89–90) and the amount of new oil-well gas dedicated to interstate commerce.

In light of the foregoing considerations, the Commission's exercise of its judgment in selecting an appropriate return was, we submit, entirely reasonable. *Bluefield Water Works & Improvement Co.* v. *Public*

Service Commission, 262 U.S. 679, 692–693; *Federal Power Commission* v. *Hope Natural Gas Co.,* 320 U.S. 591. To be sure, the Commission's opinion contains no formula demonstrating mathematically that a return of 12 percent is fair and reasonable. But such precision cannot be demanded. The determination of a fair rate of return is a matter for informed judgment, not arithmetical calculation, involving as it does not only an appraisal of the requirements of the capital market but also consideration of such factors as the needs of the future and the protection of consumer interests. In this, the heart of the ratemaking process, law cannot fix "any single formula or combination of formulas. Agencies * * * are free, within the ambit of their statutory authority, to make the pragmatic adjustments which may be called for by particular circumstances." *Federal Power Commission* v. *Natural Gas Pipeline Co.,* 315 U.S. 575, 586.

3. The specific objections directed to the Commission's determination of rate of return require only brief discussion. The producers asked for a rate of return higher than that allowed on the ground that a return is required on all producer investment, including that which is completely unproductive. The contention is, at heart, that the producers' rate base is understated unless all exploration and development expenditures are capitalized and that if they are not (as here) a higher rate of return should be allowed as an offset.

Capitalization of exploration and development expenditures would constitute a striking departure from

the traditional regulatory[20] and industry accounting practice of treating such expenditures as current expenses, and is not warranted by the record (R. 580d). No reliable evidence was presented to show an actual disparity between the book yield and the true yield for the industry as it actually operates, or what the disparity, if any, is. Indeed, the witness upon whom the producers relied testified that "the true yield concept is only of theoretical interest or value" at present (R. 1416). Furthermore, the Commission found that the producers' average weighted book yield (upon which the return allowed by the Commission is based) has been adequate to induce needed capital investment in the oil and gas industry. We may infer from this that the corresponding true yield—whatever it is—is also adequate.

The producers have also claimed that, in respect to one of the many factors considered by the Commission—namely, the earnings of the non-integrated producers—the Commission erred in treating the period from 1957–1961 as representative. They urge that a more appropriate period would have been the 1947–1961 period used by producer witness Morton. But the record clearly supports the finding that the 1957–1961 period—the most recent five-year period available at the time of the proceeding—is representative of the

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[20] In *Wisconsin* v. *Federal Power Commission*, 373 U.S. 294, Mr. Justice Clark, dissenting, expressed grave doubts as to the propriety of even the limited degree to which the Commission does permit capitalization of exploration and development expenses—for example, in connection with lease-acquisition costs incurred prior to drilling of a hole that turns out to be dry.

future earnings of the producing industry. Contrary to producers' assertion that this period was one of depressed earnings, the record shows the earnings to be fully representative of those for a much longer period. The overall return of the oil and gas producers for the period 1934–1961 was 9.44 percent and the equity return 10.46 percent. For the period 1957–1961 the overall return was 9.56 percent and the return on equity 10.44 percent (R. 923–924, 559e). In contrast, the 1947–1961 period, which producers would use, was found by the examiner to be unrepresentative (R. 200d–202d).

C. THE COMMISSION'S STANDARDS FOR DETERMINING WHEN GAS IS OF PIPELINE QUALITY AND MAY THEREFORE BE SOLD AT THE FULL AREA RATE ARE REASONABLE AND SHOULD BE SUSTAINED

1. Obviously, gas that is ready for use by a pipeline when and as delivered by the producer—pipeline-quality gas—has greater value, and should carry a higher rate, than a like quantity of gas which the pipeline must first compress (in order to achieve adequate pressure) or process (in order to remove impurities). Gas that costs 2 cents per Mcf to treat before it can be used in the pipeline is not of equal value to gas that needs no treating. If both were sold at the same price, the pipeline—and ultimately the consumer—would be paying 2 cents more for the lower quality gas. Thus, once a price to the producer for gas of pipeline quality is established, the pipeline's cost of bringing substandard gas up to that quality is a reasonable basis for setting a different price for substandard gas. Since the value of gas requiring

pipeline processing necessarily depends on the pipeline's own processing costs, and those particular costs were not explored in this proceeding, the Commission reasonably concluded that appropriate price adjustments for each sale could not be fixed by it on the basis of the present record.[21] But pipeline-quality standards could be fixed since the record contained extensive evidence as to what, in fact, those standards are in the Permian area.

The major producers urged that the Commission fix a ceiling price only. They contended that the parties could be left to negotiate adjustments for substandard gas without prescribed standards, as—allegedly—they had done in the past. But the record showed that past contracts have not in fact been consistent in giving effect to deviations from pipeline quality (R. 259–272, 164e–171e). Acceptance of the producers' proposal would thus have perpetuated substantial distortions in existing contracts and invited evasion of the area rate for the future (R. 646d–647d). Accordingly, the Commission adopted objective quality standards. At the same time, it provided that the parties should attempt to negotiate the proper adjustment for each contract, subject to Commission determination in the event the parties could not agree. (This meant that if, as the producers urged, past contracting practices accurately reflected the need for

[21] This did not—contrary to the court of appeals' assumption (XII R. 52)—mean that the overall impact of quality deductions could not be quantified. The Commission did so, relying on producer-processors' cost data and past contract provisions. That estimate has proved quite accurate (see *supra*, pp. 171–173).

adjustments where gas was of less than pipeline quality, the new negotiated adjustments could be expected to coincide with existing arrangements.) Such agreements have now been reached and approved by the Commission for virtually all sales.[22]

The producers claim that the record does not support the standards for quality determined by the Commission. They stress the examiner's conclusion (R. 249d–250d) that it is "probably impossible on this record, to establish a complete set of differentials for the various value and quality characteristics of gas." The Commission did not disagree—it recognized, as we have seen, that the exact price adjustments for each sale could not be fixed on the basis of the existing record. The examiner's statement does not, however, support the proposition that the definition of pipeline-quality *standards*—as opposed to the specification of precise price differentials for deviation therefrom—was impractical.[23]

2. The Commission ruled, with respect to Btu content, that gas containing anywhere from 1000 to 1050 Btu's was of pipeline quality. This is the only standard challenged by the producers or questioned by the court below, which said that the Commission had not

[22] The Commission's approach closely follows industry practice, as described by producers' own witness (R. 131): "Purchasers and sellers commonly avoid the problem of determining proper penalty charges in advance by agreeing that the seller shall pay the buyer's actual cost of sweetening, dehydrating and/or compressing the gas to field specifications."

[23] Since the examiner fixed specific rates on the basis of existing contract provisions, he had no occasion to fix specific standards.

adequately explained its preference for a range over a fixed figure. The range was, we submit, adequately explained and the standard is a reasonable one.

The Commission determined that the weighted average Btu content of gas-well gas in the Permian area was the appropriate guideline for upward adjustments; this figure, it found, was approximately 1042 Btu's (R. 651d). The 1050 Btu ceiling is thus eminently fair to producers. While the Commission could have used the same figure for determining when downward adjustments were appropriate, it chose instead to set the floor at 1000 Btu's—this to conform to existing Permian Basin contracts, which generally fix a minimum Btu content of 1000 Btu's although they usually make no provision for upward adjustments, and to provide reasonable leeway in the event that in the future the average Btu content should turn out to be somewhat less than 1042 or 1050 Btu's.

It is apparent, therefore, that if a single figure had been adopted there is no reason to assume, as the producers do, that it would have been 1000 Btu's. On the contrary, in view of the figures of record, a single cut off would more reasonably have approximated the average gas-well gas Btu content (*i.e.*, 1042), as was suggested by the State of California (R. 1007e–1008e). That would have entitled the producers to smaller revenues than under the Commission's decision.[24]

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[24] While this Btu standard was originally applied only to gas-well gas, on rehearing it was made applicable to all gas, including the generally richer oil-well gas. This emphasizes the fairness of the Commission's Btu standard to producers: it per-

3. The producers' remaining contention is a procedural one. It is that the Commission could make no findings with respect to quality standards or differentials at all, because, they allege, adequate notice had not been given that quality would be an issue in determining the area rates. Specifically, they contend that the Commission, by denying (through failing to act upon) a motion filed on July 26, 1962, by a number of the major producers, removed any issue of quality standards and differentials from the case. There is no merit to this suggestion. The motion (R. 69d–73d) sought to consolidate with the area proceeding a rule-making proceeding initiated by the Commission on May 22, 1961, to establish standards of pipeline quality gas for all areas of the country. In support of the motion, the producers urged that such standards could not be considered separately from the area prices. "Producers in the Permian Basin proceeding," they explained, "have introduced evidence regarding quality standards and price differentials, and plan to introduce additional evidence on such points where appropriate in that proceeding * * *" (R. 71d). That the Commission declined to consolidate a nation-wide rule-making proceeding with the Permian Basin area rate case hardly implied that it was deleting the critical quality questions from the latter proceeding. Indeed, early in this proceeding the Com-

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mits a greater upward adjustment than if the average Btu content of residue gas—which is higher—had been used as a standard for such gas (*e.g.*, R. 491e).

mission notified respondents that quality would be an issue by expressly requiring them to provide data on "actual conditions of delivery * * * for each jurisdictional sale" (R. 38d, 40d).

D. THE COMMISSION'S USE OF THE COST OF OLD GAS-WELL GAS AS A YARDSTICK FOR PRICING OIL-WELL GAS AND OLD GAS-WELL RESIDUE GAS WAS REASONABLE

1. Oil-well gas, a by-product of crude oil, may properly be priced on the basis of its value as a commodity

The Commission based the area rate for new gas-well gas on the cost of such gas, and the area rate for old gas-well gas on its cost. It treated oil-well gas (and the residue gas produced from old gas-well gas) differently. It did not attempt to derive the costs of such gas, because it concluded that such an inquiry would be impractical and fruitless.[25] And it deemed

[25] As the Commission explained (R. 622d), it "is apparent on this record, that no realistic cost of oil-well gas * * * can be established and that the various apportionments of the joint costs of gas and oil, or gas and liquids, do not yield results which may be accepted as reliable guides." This is so, it concluded, because "casinghead gas and other associated gas are found largely as a by-product of the search for oil" and "any cost-finding technique is unrealistic which assigns large sums for exploration and development to casinghead gas" (R. 574d). This view had been advanced by the producers themselves (R. 342d): "If a historical cost of service computation is deemed necessary as a point of reference for testing producer rates, we submit that such a computation should be limited to the cost of non-associated gas, because it alone may furnish a reasonable approximation of the identifiable cost of gas. The cost of associated gas is wholly dependent upon inherently discretionary allocation methods which render the results of little, if any, meaning for the purpose of measuring revenue requirements. * * *"

the rate for old gas-well gas a suitable yardstick in view of the equivalence in value of all flowing gas.[26]

The result of the Commission's analysis, then, is to establish a single price for all flowing gas (including residue), and a different and higher price for new gas-well gas (including its residue). We discuss here the propriety of the use of the old gas-well cost as a yardstick for pricing the two types of oil-well gas—residue and casinghead[27]—postponing to a later point in our argument the question whether the same yardstick was properly applied to residue gas produced from old gas-well gas (see *infra,* pp. 161–163).

Historically, the average initial base price in the Permian Basin of oil-well residue gas has been no higher than that of gas-well gas. To be sure, prices for oil-well residue gas in the Permian area have on occasion exceeded gas-well gas prices, but, as the examiner explained in some detail, this has resulted from market anomalies, and reflected temporary economic factors which are on the wane (R. 226d–231d). Actually, gas-well gas tends to have greater value than oil-well residue gas because its availability does not depend on State oil allowables, although this effect tends to be offset to some extent by the fact that oil-well residue gas is gathered by the seller; in the Per-

[26] This is not novel regulation. The Civil Aeronautics Board has fixed minimum rates for freight carried on passenger planes—for which no meaningful cost could be determined—on the basis of the cost of freight carried in freight planes. *Air Freight Rate Investigation,* 9 C.A.B. 340, 348.

[27] Residue gas is sold by a processing plant after it has extracted the liquids from the "raw" gas, which in the case of oil-well gas is sometimes called casinghead gas. Most oil-well gas in the Permian Basin is sold as residue gas (R. 621d).

mian area, at least, the buyer typically incurs the cost of gathering gas-well gas.

The producers do not directly challenge this equivalence in value; it reflects, after all, their own contracting practices. But they nonetheless argue that the Commission, in fixing the oil-well gas price ceiling at the same level as that of old gas-well gas, failed to take account of the gathering and processing costs incurred by processing plants. They point out that the old gas-well gas cost of service in the Commission's rate computations is based on costs at the wellhead, and does not include any allowance for off-lease gathering or processing.[28] However, to challenge the oil-well gas price because not all items that might be included in costing that type of gas were considered in costing the yardstick gas overlooks both that oil-well gas cannot be costed realistically and that the price equivalence accurately reflects the practices of the market.

Moreover, it is apparent that processors have not, in fact, been suffering out-of-pocket losses in selling processed gas at the wellhead price of gas-well gas. The contracts under which Permian processors buy

[28] Actually, the gas-well costs used by the Commission do reflect processing costs, although not as an expense item. The Commission expressly increased the return allowance in determining gas-well gas costs to compensate producers for the risk of finding less than pipeline quality gas at the wellhead (R. 602d, 633d). If the producer sells gas of less than pipeline quality, the ceiling price is reduced by the pipeline's cost of processing. But if the producer processes his own gas to pipeline quality, he receives the full ceiling price and, thus, the increment included in the return for processing.

most of their oil-well gas provide for the payment to the producer of a specified percentage of the sales price of the residue gas and of the liquid revenues as well. So long as the plant's costs (including return on investment) properly allocable to the residue gas revenues do not exceed its share of those revenues, it is adequately compensated for the processing function that it performs. The producers' principal witness on this subject showed that for 1960, out of an average residue gas revenue of 12.54 cents per Mcf, the processing plants paid producers 7.32 cents per Mcf and retained for themselves 5.22 cents (see R. 864e, 868e, 873e, 404d). This represented a weighted average of about 42 percent of the residue revenues. Certainly, the price of 14.5 cents allowed by the Commission for pipeline quality gas should permit the processors to retain an average amount comparable to their 1960 contract allowances, even after taking into account quality differentials.[29]

Nor is there merit to Phillips' claim below that the cost evidence presented by the Commission staff justified a higher price for oil-well residue gas than for gas-well gas. In its original presentation the staff, using an approach that allocates processing cost be-

[29] Even using the maximum average quality deduction of 1.8 cents per Mcf of residue gas, suggested by Shell in its brief below, the average price under the Commission ceilings would be 12.7 cents per Mcf and the amount retained by the plants, using the same percentage, would be about 5.33 cents per Mcf. Using average quality deductions of about .9 cents for residue gas as shown by the quality statements, (*supra*, p. 18), the average price would be about 13.6 cents per Mcf with a retained amount of about 5.7 cents per Mcf.

tween liquids and gas in proportion to their Btu's, concluded that the processing plants' costs were 5.59 cents per Mcf. Although finding none of the methods for allocating processing-plant costs proposed by the parties realistic or probative, the examiner did analyze the methods proposed (R. 336d–341d) and he found that the staff's method would be the most appropriate if any costing were attempted, but only if a 2 to 1 modified Btu allocation factor were substituted for the 1 to 1 factor used by the staff. With this adjustment for weighting costs toward the liquid Btu's—which the staff later acknowledged to be valid (R. 1116d)—the plant costs would be 4.5 cents per Mcf (R. 340d).[30] Thus, although residue gas costs are too imprecise to serve as a basis for pricing this type of gas on a cost basis, the adjusted staff study confirms the Commission's general conclusion that residue-gas costs do not exceed the price fixed for gas-well gas (R. 1112d–1113d).

Most producers agreed with the examiner and Commission that casinghead gas cannot be costed at all. It is purely a by-product of oil, and Phillips' assertions as to the high costs of producing and processing casinghead gas are without support in the record. We noted earlier (*supra,* pp. 155–157) that its value as a commodity is no greater than gas-well gas.

[30] The examiner used a rate of return of 9.5 percent. While the Commission stated that the 12 percent rate allowed for producers would be excessive for plant operations because plant operators do not encounter the same risks as explorers and developers of reserves (R. 1113d), even a 12 percent allowance would result in cost of only 4.8 cents per Mcf.

The Commission found that there was no present need to establish a separate ceiling price for casinghead gas, most of the sales of casinghead gas to producer-owned processing plants being under percentage contracts. The few sales of casinghead gas at fixed prices to processors should have no direct effect on the price paid by either the pipelines—since the residue sales from the plants will be subject to the applicable area price—or the processors, since the prices are low. Nevertheless, the Commission indicated that if any adverse effect on a processor should be shown, it would consider making special provision for him (R. 620d).

2. *The claim that the Commission's limited approval of Spraberry-type contracts discriminates against processing-plant operators is without substance.*

Phillips complains that the Commission has been unfair to producer-processors, as compared to pipeline processors, because it has permitted producers to continue selling oil-well gas directly to pipelines under Spraberry-type contracts. These contracts, as we have already noted (*supra,* p. 95), provide that the pipeline processing the gas shall pay the producer a percentage of the proceeds from the sale of the extracted liquids plus a fixed price for the residue gas leaving the pipeline plant. The examiner fixed a ceiling price of 10 cents per Mcf for old casinghead gas and 11 cents per Mcf for new casinghead gas, to be paid for the raw stream (including liquids) instead of the residue stream, and he forbade any additional compensation for the liquids extracted. In other

words he outlawed the Spraberry-type contract. While the Commission agreed with the examiner that the sale of the entire raw gas stream was subject to its jurisdiction, it concluded (R. 618d)—at the instance of the major producers, including Phillips—that Spraberry-type contracts could be retained so "long as the cost to the pipelines for residue gas under the Spraberry contracts does not exceed the applicable ceiling price for gas of similar quality." So long as the liquid revenues to the pipeline exceed or equal the processing and gathering costs, the Commission concluded, the consumer would be adequately protected by the ceiling established for residue gas. He would pay no more than the ceiling price and the producers would stand to receive substantial additional revenues from their share of the extracted liquids. This was a reasonable judgment.

3. *The pricing of residue gas derived from gas-well gas was reasonable.*

The producers argue that the Commission erred in fixing the same ceiling price for gas-well gas whether it is sold directly to the pipeline or as residue gas after processing. The producers contend that when they process gas-well gas they are performing a valuable service for which they should be recompensed by the gas consumer. This may be, but they are in fact amply compensated. If gas when purchased by the processor is below pipeline quality, the seller's price will be below the area rate, and if the processing plant improves the quality of that gas, it will be en-

titled to the full rate—a higher price than it paid for the gas.[31] In fact, the price for field gas of substandard quality is determined by reducing the pipeline-quality price by the cost of processing the gas (R. 690d). The Commission's pricing method thus allows producer plant operators a higher price if they actually improve the gas by bringing it up to pipeline quality, thereby directly compensating them for the processing service they perform on the gas quite apart from the valuable benefits accruing to them from the liquids extracted in the processing operation.

Compare the compensation allowed pipelines for their processing operations. They are allowed their costs of purchasing gas; under the Commission's decision, these will be lower than otherwise for gas that requires processing. The pipeline is allowed to add on all plant costs, but normally must credit all the liquid revenues to the cost of service[32]—whereas producer plant operators may, of course, retain their liquid revenues.

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[31] Small producers are not subject to quality deductions, and plant processors that have to pay ceiling prices for this low quality gas they process will be entitled to seek special relief. See R. 624d. However, the plant would be relieved from paying such small producers anything extra for high Btu content; in view of this factor, and the revenues from liquid extraction, special relief may, therefore, prove unwarranted.

[32] See, *e.g.*, *Cities Service Gas Co.* v. *Federal Power Commission*, 155 F. 2d 694, 703 (C.A. 10), certiorari denied, 329 U.S. 773; *Panhandle Eastern Pipe Line Co.* v. *Federal Power Commission*, 305 F. 2d 763, 767 (C.A.D.C.), certiorari denied, 372 U.S. 916; *Panhandle Eastern Pipe Line Co.* v. *Federal Power Commission*, 348 F. 2d 340 (C.A.D.C.), certiorari denied, 382 U.S. 944.

The Commission's conclusion that the same ceiling for gas-well gas is appropriate regardless of who is selling it is also consistent with past industry marketing practice (R. 1852–1853).[33] Finally, although rejecting for the future the proposal that the price for residue gas derived from gas-well gas should exceed that of gas-well gas, the Commission recognized that there might be some situations where the existing contracts of processors for gas-well gas purchases might warrant relief if proper price relationships do not now exist. Since only a small portion (3 to 4 percent) of the Permian residue gas is derived from gas-well gas, the Commission assumed that not many such situations would exist. If any producers have a meritorious ground for complaint, their recourse is, as the Commission noted, a request for special relief.[34]

[33] While Phillips challenges the Commission view (R. 624d) that there "is every reason to believe that the value of the liquids will be sufficient to justify gasoline plant processing of new gas-well gas", Phillips does not state the volumes of gas-well gas received, payments made, the extent of shrinkage and use in gasoline plants, or liquid volumes extracted and revenues. As was pointed out to the Commission (R. 478d–481d), Phillips is the principal middleman with knowledge of all the relevant facts and, when the issue was raised on the record, it could have demonstrated that a need for different prices existed notwithstanding its own contracting practices. This it failed to do.

[34] In light of the foregoing discussion, we challenge the court of appeals' statements (XII R. 43, 60) that the Commission did not specify where it had considered non-cost factors in fixing its ceiling prices. To review briefly: The price for new gas-well gas was based on the costs of such gas, the Commission concluding that non-cost factors did not warrant a price different from cost (R. 613d–614d). The price for flowing gas, by contrast, directly reflects costs only in the old gas-well gas price. As the Commission's decision makes clear, the maximum rate for all

B. THE AREA RATES PRESCRIBED BY THE COMMISSION WILL INDUCE ADEQUATE GAS SUPPLIES AT A REASONABLE COST

We close our discussion of the reasonableness of the area rates with some comments on producer contentions that the rates fixed by the Commission will not provide the reserves needed by the industry and the consuming public for the future. In our view, the area rates are wholly adequate in this respect.

Since additions to proved reserves of natural gas in the United States have exceeded production in every year, the Commission properly concluded that the level of producer expenditures for exploration and development in the period 1960–1964—a level that had proved

---

casinghead gas and residue gas derived from casinghead gas, which accounts for almost two-thirds of the gas in the Permian Basin, was determined on a value rather than cost basis—by using the costs of old gas-well gas as a bench mark or yardstick for pricing such oil-well gas. The Commission found that costs for oil-well gas—which is largely a by-product of the search for and production of oil—and the residue gas derived therefrom could not be determined with sufficient accuracy to use as a pricing standard. The Commission also found that while the specific costs for oil-well gas, either at the wellhead or at the tailgate of a processing plant, could not be fixed for pricing purposes, the record demonstrated that these costs were lower than those for gas-well gas at the wellhead. Nevertheless the Commission fixed the same ceiling for oil-well gas and the residue derived therefrom as it did for old gas-well gas in view of the past market history recognizing value equivalence of wellhead sales as gas-well gas and tailgate sales of oil-well gas. While casinghead gas sold at the wellhead has a lesser value, the Commission concluded that the preponderance of such sales in the Permian area were on a percentage basis or at such low contract prices that a separate pricing standard was unnecessary (R. 615d–621d).

sufficient to assure adequate reserves—was the appropriate basis for calculating the allowance for costs of exploration and development in the area rate for new gas-well gas. And since the industry will recoup its exploratory expenses from the revenues of current production, as production increases so will the sums available for further exploration. This means that exploration should generally continue to yield findings in excess of production despite increases in production (R. 583d).

In making these findings, the Commission rejected the producers' claim that the ratio of reserves to production was being permitted to decline to a dangerous level and their prediction that a gas shortage would result unless rates much higher than those fixed by the Commission were provided (R. 558d–563d). It is notable that pipelines and distributors—whose interest in an adequate long-term gas supply is certainly no less than the producers (see, *e.g.*, R. 125d)— presented evidence that a decline in the present R/P ratio was desirable, that no gas supply shortage existed, and indeed that there was at least a temporary oversupply of gas (see R. 1095, 1103, 803e–805e). The record shows that pipelines had been encountering some difficulty lately in reselling the gas which they had contracted to purchase (*e.g.*, R. 472–478, 502–503, 505, 1098–1100, 1399–1400). In 1962 El Paso had a balance of $13,380,578 in required prepayment for gas which it was entitled to but had not taken (R. 1387–1388). Northern's balance was $2,224,666 for "take or pay"

payments (R. 1104), while Transwestern's prepayments had grown to $677,062 (R. 1618).[35]

Moreover, contrary to the producers' contention that the new gas-well gas ceiling of 16.5 cents is inadequate to induce needed exploratory efforts, the record indicates that very substantial uncommitted reserves were available in the Permian Basin at prices not exceeding the 16-cent guideline ceiling announced for the area on September 28, 1960 (R. 1103, 1384–1386, 1618–1620). The Policy Statement ceiling price of 16 cents applied to pipeline quality gas (24 FPC 818, 819–820). As Commissioner O'Connor pointed out in his concurring opinion in this case (R. 746d–748d), substantial volumes of gas were sold at or below that price. Yet, by the area rate prescribed in this proceeding the Commission has raised the ceiling.

The foregoing considerations (only a sample of the factors weighed by the examiner and the Commission) amply support the Commission's conclusion that the price fixed for new gas-well gas—the only type of gas substantially responsive to price—is reasonably calculated to elicit adequate supplies of gas to maintain an excess of findings over production. There is, indeed, every indication that the incentive to search for gas in the Permian Basin area is unabated. See, *e.g., Gas Reserves Zooming in the Delaware,* Oil and Gas Jour-

[35] The right to take gas under these prepayments is limited. After the right expires the prepayments are charged to purchases; in the meantime, they enter the pipeline rate base and thereby augment the pipeline's return and related income tax allowances charged annually to consumers, unless the pipeline was imprudent in making the contract.

nal, June 13, 1966, p. 62; *Delaware Basin Score is 55,* Oil and Gas Journal, March 6, 1967, p. 139; *New Outlets to Spur Permian Drilling,* Oil and Gas Journal, April 10, 1967, p. 53. The claim that the Commission failed to consider adequately the effect of price on supply is reminiscent of contentions in *Federal Power Commission* v. *Hope Natural Gas Co.,* 320 U.S. 591, where this Court said (*id.* at 615):

> It is suggested that the Commission has failed to perform its duty under the Act in that it has not allowed a return for gas production that will be enough to induce private enterprise to perform completely and efficiently its functions for the public. The Commission, however, was not oblivious of those matters. It considered them. It allowed, for example, delay rentals and exploration and development costs in operating expenses. No serious attempt has been made here to show that they are inadequate. We certainly cannot say that they are, unless we are to substitute our opinions for the expert judgment of the administrators to whom Congress entrusted the decision. * * * [Footnote omitted.]

Recognizing the desirability of testing rates against experience, the Court added (*id.* at 615):

> * * * [I]f in light of experience they turn out to be inadequate for development of new sources of supply, the doors of the Commission are open for increased allowances. This is not an order for all time. * * *

These conclusions apply with equal force here.

IV

THE INTEREST ON AMOUNTS COLLECTED IN EXCESS OF THE APPLICABLE AREA RATE AFTER THE EFFECTIVE DATE FOR RATE REDUCTIONS REQUIRED BY THE COMMISSION SHOULD BE COMPUTED ON THE BASIS OF THE 7-PERCENT RATE SPECIFIED BY THE COMMISSION IN ITS OPINION, NOT THE 4½ PERCENT RATE INDICATED BY THE COURT IN ITS STAY ORDER

The Commission specifically provided that the reduced rates it was prescribing would become effective on September 1, 1965 (R. 698d), and that any amounts subsequently collected in excess of the applicable area rate would be subject to refund with simple interest at 7 percent (R. 691d).[86] This provision was not challenged in the applications for rehearing to the Commission. Upon dissolution of the stay entered by the court below on January 20, 1966 (XII R. 12), it should be controlling as to the rate of interest for the period commencing September 1, 1965, since under Section 19(b) of the Gas Act the reviewing court has no authority to set aside any part of a Commission order that has not been challenged in an application for rehearing (*supra*, pp. 56–57, n. 34). Nevertheless, the court below, in its stay order of January 20, 1966 (entered at the producers'

[86] The provision for such refunds was necessary since the rate reductions might not be implemented immediately, even in the absence of a stay of their effectiveness, because of the need to determine the quality deductions (if any) for each sale (*supra*, pp. 150–151).

request), stated that amounts collected for sales after September 1, 1965, while subject to refund, may either be paid in escrow, or commingled with company assets in which event refunds would bear interest at 4½ percent.

The court did not explain why it was specifying a 4½ percent interest rate, but apparently it accepted the producers' arguments that such a rate would be consistent with the 4½ percent interest rate prescribed by the Commission with respect to certain other refund obligations (see R. 695d–696d). The situations are not comparable. The Commission's order required producers to make refund reports showing amounts due for the period prior to September 1, 1965, including interest to the date of the report at the rate (either 6 or 7 percent) specified in the Commission's original orders suspending rate increases.[37] However, rather than require immediate refund of these reported amounts, the Commission, in conformity with the principles established in *Humble Oil and Refining Co.*, 32 F.P.C. 49, 52, directed the producers to retain the amounts pending determination by the Commission of the proper distribution of the refunds (R. 675d, 696d). At this point further retention of the refunds by producers was at the direction

[37] Under Section 4 of the Act, rates collected after a Commission suspension order are subject to refund. This is the basis of refund liability respecting sales antedating the effective date of the area rates.

of the Commission and in that limited circumstance the Commission deemed a 4.5 percent rate (the prime interest rate when this order was issued) appropriate. *Reserve Oil and Gas Co.*, 35 F.P.C. 309, 310. But there is no such Commission-directed retention of funds when, as here, producers seek review of a rate reduction order and obtain a stay thereof. See *Continental Oil Co., et al.* v. *Federal Power Commission*, C.A. 5, Nos. 23188, *et al.*, May 24, 1967, slip op. pp. 20–21, pending on petition for a writ of certiorari, No. 504, O.T. 1967; *Pan American Petroleum Co.* v. *Federal Power Commission*, 376 F. 2d 161, 170–171, n. 12 (C.A. 10).[38]

CONCLUSION

The motions for leave to adduce additional evidence should be denied,[39] the judgments of the court of appeals reversed, and the cases remanded to that court

[38] In *Pan American*, the court below approved the Commission's 7 percent interest rate on refunds not held involuntarily, even though the court's attention was drawn to its inconsistent order in the instant case.

[39] These motions seek permission to present additional evidence on a number of points, such as the revenue impact of quality deductions and low contract prices, individual companies' costs of service and the alleged staleness of the record. The motions are based upon the same grounds as the producers' objections, discussed in this brief, to the Commission's decision, and they should be denied for the same reasons that we have urged for rejecting the objections.

with directions to sustain the Commission's orders in their entirety.

Respectfully submitted.

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AUGUST 1967.

APPENDIX

APPENDIX

The Natural Gas Act, June 21, 1938, c. 556, 52 Stat. 821–833, as amended, 15 U.S.C. 717–717w provides in pertinent part as follows:

> SEC. 4. (a) All rates and charges made, demanded, or received by any natural-gas company for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges, shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful.
>
> * * * * *
>
> (c) Under such rules and regulations as the Commission may prescribe, every natural-gas company shall file with the Commission, within such time (not less than sixty days from the date this act takes effect) and in such form as the Commission may designate, and shall keep open in convenient form and place for public inspection, schedules showing all rates and charges for any transportation or sale subject to the jurisdiction of the Commission, and the classifications, practices, and regulations affecting such rates and charges, together with all contracts which in any manner affect or relate to such rates, charges, classifications, and services.
>
> (d) Unless the Commission otherwise orders, no change shall be made by any natural-gas company in any such rate, charge, classification, or service, or in any rule, regulations, or contract relating thereto, except after thirty days' notice to the Commission and to the pub-

lic. Such notice shall be given by filing with the Commission and keeping open for public inspection new schedules stating plainly the change or changes to be made in the schedule or schedules then in force and the time when the change or changes will go into effect. The Commission, for good cause shown, may allow changes to take effect without requiring the thirty days' notice herein provided for by an order specifying the changes so to be made and the time when they shall take effect and the manner in which they shall be filed and published.

(e) Whenever any such new schedule is filed the Commission shall have authority, either upon complaint of any State, municipality, State Commission, or gas distributing company or upon its own initiative without complaint, at once, and if it so orders, without answer or formal pleading by the natural-gas company, but upon reasonable notice, to enter upon a hearing concerning the lawfulness of such rate, charge, classification, or service; and, pending such hearing and the decision thereon, the Commission, upon filing with such schedules and delivering to the natural-gas company affected thereby a statement in writing of its reasons for such suspension, may suspend the operation of such schedule and defer the use of such rate, charge, classification, or service, but not for a longer period than five months beyond the time when it would otherwise go into effect; and after full hearings, either completed before or after the rate, charge, classification, or service goes into effect, the Commission may make such orders with reference thereto as would be proper in a proceeding initiated after it had become effective. If the proceeding has not been concluded and an order made at the expiration of the suspension period, on motion of the natural-gas company making the filing, the proposed change of rate, charge, classification, or

service shall go into effect. Where increased rates or charges are thus made effective, the Commission may, by order, require the natural-gas company to furnish a bond, to be approved by the Commission, to refund any amounts ordered by the Commission, to keep accurate accounts in detail of all amounts received by reason of such increase, specifying by whom and in whose behalf such amounts were paid, and, upon completion of the hearing and decision, to order such natural-gas company to refund, with interest, the portion of such increased rates or charges by its decision found not justified. At any hearing involving a rate or charge sought to be increased, the burden of proof to show that the increased rate or charge is just and reasonable shall be upon the natural-gas company, and the Commission shall give to the hearing and decision of such questions preference over other questions pending before it and decide the same as speedily as possible.

SEC. 5. (a) Whenever the Commission, after a hearing had upon its own motion or upon complaint of any State, municipality, State commission, or gas distributing company, shall find that any rate, charge, or classification demanded, observed, charged, or collected by any natural-gas company in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order: *Provided, however,* That the Commission shall have no power to order any increase in any rate contained in the cur-

rently effective schedule of such natural-gas company on file with the Commission, unless such increase is in accordance with a new schedule filed by such natural-gas company; but the Commission may order a decrease where existing rates are unjust, unduly discriminatory, preferential, otherwise unlawful, or are not the lowest reasonable rates.

* * * * *

SEC. 7. (b) No natural-gas company shall abandon all or any portion of its facilities subject to the jurisdiction of the Commission, or any service rendered by means of such facilities, without the permission and approval of the Commission first had and obtained, after due hearing, and a finding by the Commission that the available supply of natural gas is depleted to the extent that the continuance of service is unwarranted, or that the present or future public convenience or necessity permit such abandonment.

(c) No natural-gas company or person which will be a natural-gas company upon completion of any proposed construction or extension shall engage in the transportation or sale of natural gas, subject to the jurisdiction of the Commission, or undertake the construction or extension of any facilities therefor, or acquire or operate any such facilities or extensions thereof, unless there is in force with respect to such natural-gas company a certificate of public convenience and necessity issued by the Commission authorizing such acts or operations: *Provided, however,* That if any such natural-gas company or predecessor in interest was bona fide engaged in transportation or sale of natural gas, subject to the jurisdiction of the Commission, on the effective date of this amendatory Act, over the route or routes or within the area for which application is made and has so operated since that time, the Com-

mission shall issue such certificate without requiring further proof that public convenience and necessity will be served by such operation, and without further proceedings, if application for such certificate is made to the Commission within ninety days after the effective date of this amendatory Act. Pending the determination of any such application, the continuance of such operation shall be lawful.

In all other cases the Commission shall set the matter for hearing and shall give such reasonable notice of the hearing thereon to all interested persons as in its judgment may be necessary under rules and regulations to be prescribed by the Commission; and the application shall be decided in accordance with the procedure provided in subsection (e) of this section and such certificate shall be issued or denied accordingly: *Provided, however,* That the Commission may issue a temporary certificate in cases of emergency, to assure maintenance of adequate service or to serve particular customers, without notice or hearing, pending the determination of an application for a certificate, and may by regulation exempt from the requirements of this section temporary acts or operations for which the issuance of a certificate will not be required in the public interest.

* * * * *

(e) Except in the cases governed by the provisos contained in subsection (c) of this section, a certificate shall be issued to any qualified applicant therefor, authorizing the whole or any part of the operation, sale, service, construction, extension, or acquisition covered by the application, if it is found that the applicant is able and willing properly to do the acts and to perform the service proposesd and to conform to the provisions of the Act and the requirements, rules, and regulations of the Commission thereunder, and that the proposed

service, sale, operation, construction, extension, or acquisition, to the extent authorized by the certificate, is or will be required by the present or future public convenience and necessity; otherwise such application shall be denied. The Commission shall have the power to attach to the issuance of the certificate and to the exercise of the rights granted thereunder such reasonable terms and conditions as the public convenience and necessity may require.

* * * * *

SEC. 16. The Commission shall have power to perform any and all acts, and to prescribe, issue, make, amend, and rescind such orders, rules, and regulations as it may find necessary or appropriate to carry out the provisions of this act. Among other things, such rules and regulations may define accounting, technical, and trade terms used in this act; and may prescribe the form or forms of all statements, declarations, applications, and reports to be filed with the Commission, the information which they shall contain, and the time within which they shall be filed. Unless a different date is specified therein, rules and regulations of the Commission shall be effective thirty days after publication in the manner which the Commission shall prescribe: Orders of the Commission shall be effective on the date and in the manner which the Commission shall prescribe. For the purposes of its rules and regulations, the Commission may classify persons and matters within its jurisdiction and prescribe different requirements for different classes of persons or matters. All rules and regulations of the Commission shall be filed with its secretary and shall be kept open in convenient form for public inspection and examination during reasonable business hours.

* * * * *

SEC. 19 (a) Any person, State, municipality, or State commission aggrieved by an order issued by the Commission in a proceeding under this act to which such person, State, municipality, or State commission is a party may apply for a rehearing within thirty days after the issuance of such order. The application for rehearing shall set forth specifically the ground or grounds upon which such application is based. Upon such application the Commission shall have power to grant or deny rehearing or to abrogate or modify its order without further hearing. Unless the Commission acts upon the application for rehearing within thirty days after it is filed, such application may be deemed to have been denied. No proceeding to review any order of the Commission shall be brought by any person unless such person shall have made application to the Commission for a rehearing thereon. Until the record in a proceeding shall have been filed in a court of appeals, as provided in subsection (b), the Commission may at any time, upon reasonable notice and in such manner as it shall deem proper, modify or set aside, in whole or in part, any finding or order made or issued by it under the provisions of this Act.

(b) Any party to a proceeding under this act aggrieved by an order issued by the Commission in such proceeding may obtain a review of such order in the circuit court of appeals of the United States for any circuit wherein the natural-gas company to which the order relates is located or has its principal place of business, or in the United States Court of Appeals for the District of Columbia, by filing in such court, within sixty days after the order of the Commission upon the application for rehearing, a written petition praying that the order of the Commission be modified or set aside in whole or in part. A copy of such

petition shall forthwith be transmitted by the clerk of the court to any member of the Commission and thereupon the Commission shall file with the court the record upon which the order complained of was entered, as provided in section 2112 of title 28, United States Code. Upon the filing of such petition such court shall have jurisdiction, which upon the filing of the record with it shall be exclusive, to affirm, modify, or set aside such order in whole or in part. No objection to the order of the Commission shall be considered by the court unless such objection shall have been urged before the Commission in the application for rehearing unless there is reasonable ground for failure so to do. The finding of the Commission as to the facts, if supported by substantial evidence, shall be conclusive. If any party shall apply to the court for leave to adduce additional evidence, and shall show to the satisfaction of the court that such additional evidence is material and that there were reasonable grounds for failure to adduce such evidence in the proceedings before the Commission, the court may order such additional evidence to be taken before the Commission and to be adduced upon the hearing in such manner and upon such terms and conditions as to the court may seem proper. The Commission may modify its findings as to the facts by reason of the additional evidence so taken, and it shall file with the court such modified or new findings, which if supported by substantial evidence, shall be conclusive, and its recommendation, if any, for the modification or setting aside of the original order. The judgment and decree of the court, affirming, modifying, or setting aside, in whole or in part, any such order of the Commission, shall be final, subject to review by the Supreme Court of the United States upon certiorari or certification as provided in [former] sections

239 and 240 of the Judicial Code, as amended (U.S.C., title 28, sec. 1254).

(c) The filing of an application for rehearing under subsection (a) shall not, unless specifically ordered by the Commission, operate as a stay of the Commission's order. The commencement of proceedings under subsection (b) of this section shall not, unless specifically ordered by the court, operate as a stay of the Commission's order.

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SUPREME COURT, U. S.

No. 100

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In the Supreme Court of the United States

OCTOBER TERM, 1967

PEOPLE OF THE STATE OF CALIFORNIA and PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA,

Petitioners,

vs.

SKELLY OIL COMPANY,
PHILLIPS PETROLEUM COMPANY,
WARREN PETROLEUM CORPORATION,
MOBIL OIL CORPORATION (formerly Socony Mobil Oil Company, Inc.),
PAN AMERICAN PETROLEUM CORPORATION,
NORTHERN NATURAL GAS PRODUCING COMPANY,

[*Continued on Inside Cover.*]

On Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

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August 24, 1967

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W. H. Hunt,
Secure Trusts,
Caroline and Loyd B. Sands,
Caroline Hunt Trust Estate,
Lyda Hunt-Caroline Trusts,
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Lyda Hunt-Lamar Trusts,
Lyda Hunt-Herbert Trusts,
Lyda Hunt-Margaret Trusts
(formerly Estate of Lyda Bunker Hunt, Deceased),
Hunt Industries
(formerly Estate of Lyda Bunker Hunt, Deceased), and
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Cities Service Oil Company
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Cities Service Production Company
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Amerada Petroleum Corporation,
Union Oil Company of California and as successor to
The Pure Oil Company,
Tidewater Oil Company,
Reef Corporation, and
William A. & Edward R. Hudson, Joint Operators,
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ASSOCIATION jointly with
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STATE OF NEW MEXICO,
GULF OIL CORPORATION, and
J. C. BARNES, *et al.*,

(THE PERMIAN BASIN AREA RATE CASES)

Respondents.

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PETITIONER'S BRIEF

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In the Supreme Court of the United States

OCTOBER TERM, 1967

No. 100

PEOPLE OF THE STATE OF CALIFORNIA and PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA,
Petitioners,

vs.

SKELLY OIL COMPANY, et al.,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

Brief for the People of the State of California and the Public Utilities Commission of the State of California

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Tenth Circuit, issued on January 20, 1967 (XII R. 12-61),[1] and its *per curiam* opinion and order on rehearing,

1. The record in this Court consists of fourteen volumes, thirteen of which constituted the joint appendix in the Court of Appeals. Volumes I-V, which contain only testimony before the Commission, are paginated 1-1908 (bottom of page) and will be cited "R. 1 - R. 1908". Volumes VI-VIII, which contain exhibits presented during the hearings, are paginated 1e-1146e and will be cited "R.

issued on April 18, 1967 (XII R. 87-9), are reported at 375 F. 2d 6 (10th Cir. 1967). The Federal Power Commission's Opinion and Order Determining Just and Reasonable Rates for Natural Gas Producers in the Permian Basin, Docket No. AR61-1, *et al.* (Opinion No. 468), the related Order Issuing Certificates, and the related Order to Show Cause issued on August 5, 1965 (R. 516d-838d, 37s-40s), are reported at 34 FPC 159, 418, and 424 respectively; and its Opinion and Order Denying Applications for Rehearing of Opinion No. 468, Docket No. AR61-1, *et al.* (Opinion No. 468-A), issued on October 4, 1965 (R. 1105d-1136d), are reported at 34 FPC 1068. The initial decision of the Presiding Examiner, issued on September 17, 1964 (R. 97d-364d), is reported at 34 FPC 306.

JURISDICTION

The judgment of the Court of Appeals remanding the opinions and orders of the Federal Power Commission was entered on January 20, 1967. The *per curiam* opinion and order of the Court of Appeals denying rehearing was entered on April 18, 1967. The People of the State of California and the Public Utilities Commission of the State of California (California), petitioners herein, did not petition for rehearing before the Court of Appeals. A petition for a writ of certiorari was filed on April 19, 1967. A motion to supplement this petition was filed on May 4, 1967. Both the petition for a writ of certiorari and the motion to supplement it were granted on June 12, 1967. 26 U.S.L.

1e - R. 1146e". Volumes IX-XI, which contain pleadings, orders, and opinions in the Commission proceedings, are paginated 1d-1157d and will be cited "R. 1d - R. 1157d". Volume XII (the only tan-covered volume), which includes the decision of the Court of Appeals and other items from the file in the court below, is numbered 1-90 and will be cited "XII R. 1-90". There are also two small volumes—a supplement to the joint appendix below paginated 1s-40s, and a table of contents for Volumes I-XI.

Week 3437 (U.S. June 13, 1967) (No. 1293, 1966 Term; renumbered No. 100, 1967 Term).

The jurisdiction of this Court is invoked under the provisions of 28 U.S.C. 1254(1) and Section 19(b) of the Natural Gas Act.[2]

QUESTIONS PRESENTED

1. In determining just and reasonable area rates under Sections 4 and 5 of the Natural Gas Act, must the Federal Power Commission, in order to satisfy the "end result" test set forth in *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591 (1944), determine the allowable area cost of service for the gas produced in the area, including an allowance for exploration to meet future demand for gas, find that such cost of service constitutes the area revenue requirement, and establish rates which will recover such revenue requirement; or may it determine area rates which establish a fair relationship between the revenues derived from the rates prescribed and the allowable area cost of service?

2. Where *Federal Power Commission v. Sierra Pacific Power Company*, 350 U.S. 348 (1956), holds that voluntarily made contract rates, which are below the Federal Power Commission's subsequently determined just and reasonable rates, are not required to be raised to the same level as the just and reasonable rates unless the public interest so necessitates, must the Commission raise these low contract rates for the purpose of insuring that area revenues equal the Commission's determination of allowable area costs?

3. In establishing group ceiling rates applicable to pipeline quality gas, is the Commission's rate-of-return allowance of 12 percent adequate where specific recognition was

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2. Act of June 21, 1938, c. 556, § 19, 52 Stat. 831, as amended 15 U.S.C. 717r (1958).

given to the fact that lower quality gas commanding a lesser price might be found and where this possibility was treated as an additional risk?

4. Where the Federal Power Commission has determined just and reasonable area rates, must area revenues exceed the allowable area cost of service before refunds of contract rates collected subject to refund under Section 4 of the Act may be ordered?

5. Did the Federal Power Commission err by establishing a special relief provision which announces that producers may petition for relief from the prescribed area rates but which does not specify detailed guidelines for such relief?

6. Did the Federal Power Commission give adequate notice that it would prescribe quality standards in this proceeding, and is its decision so vague and unclear with regard to the establishment of the "Btu gap" in its Btu quality standard that clarification is required?

7. Where the Federal Power Commission has determined just and reasonable area rates under Sections 4 and 5 of the Natural Gas Act, may the Commission find that such area rates prospectively constitute the initial price for certificating sales in the area under Section 7 of the Act?

STATUTES INVOLVED

The relevant provisions of the Natural Gas Act (Act of June 21, 1938, c. 556, 52 Stat. 821-833, as amended, 15 U.S.C., Sections 717-717w) are set forth in the appendix to this brief.

STATEMENT

The opinions and orders of the Federal Power Commission (Commission) remanded by the court below establish just and reasonable rates for jurisdictional gas sold

in a specific geographic area—the Permian Basin of west Texas and southeastern New Mexico. Opinion Nos. 468 and 468-A represent the first attempt by the Commission to regulate the rates of independent producers on an area basis. Area rate making under the Natural Gas Act is the product of a long administrative and legal struggle to find a workable and effective approach to producer regulation.

A. California's Interest in Federal Regulation of Natural Gas Producers

California intervened in the proceedings before the Commission and in the review proceedings in the Court of Appeals below because most of the gas exported from the Permian Basin is consumed in California.[3] Residents of California must ultimately pay the rates determined by the Commission in the orders now before this Court for review. These orders result in rate reductions and substantial refunds which will flow through to ultimate consumers in California. California is therefore vitally interested in this proceeding.

The court below made little or no mention of the primary purpose of the Natural Gas Act, which this Court has said is "to protect consumers against exploitation at the hands of natural gas companies." *Federal Power Commission v. Hope Natural Gas Company,* 320 U.S. 591, 611 (1944) And, more recently, this Court stated: "The Act was so framed as to afford consumers a complete, permanent and effective bond of protection from excessive rates and charges." *Atlantic Refining Company, et al. v. Public Service Commission of New York,* 360 U.S. 378, 388 (1959) In the con-

3. In 1965 alone, slightly more than 66% of the Basin's production dedicated to interstate sales was delivered to the California market.

text of this case, California represents the consumers who are to be protected by regulation under the Act.

An understanding of California's need for natural gas and the sources from which that need is met is important in evaluating California's interest in federal regulation of producers.

California's interest in effective producer regulation is unusually great. California is the largest state in the Union, having a current population in excess of 19,000,000. The State depends on natural gas as the basic source of residential and industrial energy. Not only is gas used directly for space heating, water heating, air conditioning and cooking, but it provides in large measure the energy used for generating electricity. Unlike other areas of the nation, coal is not an economical alternative to natural gas for meeting California's energy requirements for space and water heating.

California consumes approximately 13.3 percent of all the gas sold in the United States. Almost 75 percent of the supply of natural gas needed to meet the demands of the California market is furnished from sources beyond the borders of the State, while the remainder is drawn from wells within California. Of the out-of-state supply, 87 percent is transported to California by El Paso Natural Gas Company (El Paso) and Transwestern Pipeline Company (Transwestern) from sources principally in Texas, New Mexico, and Oklahoma; and 13 percent is imported from Canada and transported to California by Pacific Gas Transmission Company (P.G.T.).

The producers' rates for gas sold to El Paso and Transwestern are subject to the regulatory jurisdiction of the Commission. The Commission also regulates the rates charged by these pipeline companies for the sale of gas at the Arizona-California border to the California public utili-

ty gas distributing corporations, namely, Pacific Gas and Electric Company (P.G.&E.), serving northern California and Pacific Lighting Service and Supply Company, Southern California Gas Company, and Southern Counties Gas Company of California (Pacific Lighting Companies) serving southern California.[4] The residential and industrial rates of these California public utility gas distributors are regulated by the California Public Utilities Commission.

It is apparent that protection of California gas consumers begins with effective regulation of producers by the Commission. This explains California's interest in the proceedings below and in the review proceeding now before this Court.

B. Historical Background to the First Area Rate Decision

On June 7, 1954, this Court, in *Phillips Petroleum Company v. Wisconsin*, 347 U.S. 672 (1954), decided that independent producers are natural gas companies within the meaning of the Natural Gas Act. Sales by producers for resale in interstate commerce are therefore subject to the regulatory jurisdiction of the Commission.

In response to its newly found obligation to regulate the rates of independent producers, the Commission went forward under Section 5(a) of the Act with an investigation of the rates and charges of Phillips Petroleum Company (Phillips). On September 28, 1960, the Commission issued Opinion No. 338[5] terminating both the rate investigation

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4. The Pacific Lighting Companies resell gas to San Diego Gas and Electric Company (S.D.G.&E.). P.G.&E., the Pacific Lighting Companies, and S.D.G.&E. are also petitioners in this proceeding.

5. *Phillips Petroleum Company*, Docket Nos. G-1148, *et al.*, 24 FPC 537 (1960).

and the consolidated Section 4(e) rate increase proceedings.[6]

The Commission rejected individual company cost-of-service rate making as a basis for fixing Phillips' future rates under Section 5(a), and announced that it would attempt to regulate producers through the development of area rates. At the same time the Commission issued its Statement of General Policy No. 61-1.[7] The purpose of the policy statement was to announce price levels for the various gas producing areas of the nation which would provide guidance to the Commission in certificating initial sales of gas and in suspending rate increase applications. The policy statement guideline price levels have served as an interim form of producer regulation pending the issuance of the Commission's first area rate decision.

California and the states of New York and Wisconsin, as well as several eastern gas distributing utilities, sought review of Opinion No. 338 in the Court of Appeals for the District of Columbia Circuit. The Court of Appeals denied the petitions for review, affirming Opinion No. 338.[8] On May 20, 1963, this Court affirmed the judgment of the Court of Appeals. *Wisconsin v. Federal Power Commission,* 373 U.S. 294 (1963). This Court held that individual company cost-of-service rate making was not the sole method of natural gas rate regulation, and although the question of the legality of area rate making was not before the Court for decision, the Commission was not prohibited from commencing the use of this method.

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6. Two of the Section 4(e) dockets were left open, pending determination of issues involving contractual support for the rate increases in question.

7. 24 FPC 818 (1960), 18 C.F.R. 2.56, as amended.

8. *Wisconsin v. Federal Power Commission,* 303 F.2d 380 (D.C. Cir. 1961).

C. The Proceeding Before the Commission

The Commission selected the Permian Basin as the first area with respect to which just and reasonable producer rates would be determined by use of the area rate making technique. On December 23, 1960, the Commission instituted a Section 5(a) investigation of the rates of producers relating to jurisdictional sales of natural gas produced in the Basin. Existing Section 4(e) rate increase proceedings and several Section 7 certificate proceedings involving gas produced in the Basin were consolidated with the investigation. Thus the Commission would be in a position to determine just and reasonable area rates for the future and to apply such area rates (1) in determining whether suspended increased rates, collected subject to refund, should be allowed or refunded in whole or in part, and (2) in determining the price at which an initial sale should be certificated in terms of the public convenience and necessity.

The proceeding commenced on October 11, 1961, and ultimately involved 251 days of hearing, a transcript containing 30,369 pages, and some 337 exhibits. On September 12, 1963, the hearings were concluded. Briefs were filed by the parties, and the matter was submitted to the Examiner for an initial decision.

1., THE PRESIDING EXAMINER'S INITIAL DECISION

The initial decision was issued on September 17, 1964.

The Examiner determined area ceiling rates for various types of gas within two major categories—new and old gas. The fixing of prices for new and old gas has come to be known as the two-price system.

The Examiner found that producers could direct, to some extent, their exploration activities in a search for either gas or oil. This meant that a price for new gas-well gas

could serve the economic function of eliciting supplies of gas, because the price of oil would play no part in motivating the separately determined search for gas reservoirs.[9] In accordance with this economic approach, the price for new gas-well gas would be based on higher current costs—as opposed to lower historical costs. Thus the rate fixed for new gas-well gas would be higher than the rate fixed for old gas-well gas. This higher rate could therefore serve as an incentive to producers to explore for gas reservoirs and to dedicate new supplies of gas to the interstate market.

The Examiner selected December 23, 1960,[10] as the date dividing new and old gas.

The core of the initial decision was the Examiner's determination of an area ceiling price for new gas-well gas. The estimated national current cost of finding and producing new gas-well gas, including return at 12 percent, was related to the Permian Basin area by the application of a value-based geographical discount. This resulted in an average area price. A "gold standard" allowance was added to the average price to obtain the area ceiling price. "The gold standard is the premium above the average price for superior quality and value." (R. 246d)

The area ceiling price for new gas-well gas governed the area ceiling price for new residue gas, i.e., residue gas derived from new gas-well gas. Separate rates were also determined for new casinghead gas.

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9. Gas-well gas is gas produced from gas only and gas condensate reservoirs. It is gas not found in association with crude oil. Gas-well gas is to be distinguished from casinghead gas, or oil well gas. Casinghead gas is produced in conjunction with oil from crude-oil reservoirs. Either casinghead gas or gas-well gas from gas condensate reservoirs may be sent through a gasoline plant where liquid hydrocarbons are extracted and later sold. The gas emanating from the tail-gate of the plant is known as residue gas.

10. This was the date on which the proceedings were instituted.

The area ceiling price for old gas-well gas was determined by "deflating" the cost based revenue standard for new gas-well gas. The area ceiling prices for old residue and old casinghead gas were, in turn, related to the old gas-well gas price in terms of relative value.[11]

It should be noted that, although determining area ceiling rates by inclusion of a gold standard for superior quality and value, the Examiner nevertheless failed to provide for deductions from the ceiling price, where gas was of less than pipeline quality.[12]

2. THE COMMISSION'S DECISION

Many parties having filed exceptions to the initial decision, the Commission heard oral argument on February 8, 9, and 10, 1965. Its decision, Opinion No. 468, was issued on August 5, 1965.

The Commission adopted the two-price system and determined base area ceiling rates for new gas-well gas and old

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11. The area ceiling prices determined by the Presiding Examiner were:

	New (Cents per Mcf)	Old (Cents per Mcf)
Gas-well gas	16.75	13.5
Residue gas	16.75	13.5
Casinghead gas	11.00	10.0

12. The foregoing description of the Examiner's initial decision has been confined to a brief review of the derivation of the area ceiling rates. The Examiner also determined minimum rates for gas-well gas and residue gas (9 cents per Mcf) and for casinghead gas (7 cents per Mcf). The decision covered other subjects, such as exemption from regulation for small producers, prohibition of certain price escalation clauses in producer contracts, computation of refunds on an area basis, and provision for special relief for individual producers where imposition of the group rates would lead to serious injustice.

(flowing) gas.[13] The Commission selected January 1, 1961, as the date dividing new and flowing gas. Separate prices were not established for types of gas, i.e., gas-well gas, residue gas, and casinghead gas.

In determining the base area rate for new gas-well gas, the Commission utilized the estimated national current cost of finding and producing new gas-well gas, including return computed at a rate of 12 percent. The Commission rejected the use of a geographical discount and a gold standard premium.

In determining the base area ceiling price for flowing gas, the Commission relied upon the 1960 area historical cost of service, including a return of 12 percent, applicable to flowing gas-well gas. This cost was used as a yardstick for the pricing of flowing residue and all casinghead gas.

The base area ceiling rates were to apply to sales of pipeline quality gas. Downward adjustment from the base area rates were to be made for deviations from the pipeline quality standards defined by the Commission for hydrogen sulphide, sulphur, carbon dioxide, water, and delivery pressure. Both a downward and an upward adjustment were prescribed to reflect quality differentials respecting Btu content. The Btu adjustment, either upward or downward, would apply only to the base area rates for new gas-well gas and residue gas derived therefrom. The rate resulting

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13. These Permian Basin base area rates are:

Texas, Including Production Taxes	
New Gas-Well Gas*	16.5 cents per Mcf.
Flowing Gas	14.5 cents per Mcf.
New Mexico, Production Taxes to Be Added	
New Gas-Well Gas*	15.5 cents per Mcf.
Flowing Gas	13.5 cents per Mcf.

*The ceiling price for new gas-well gas is applicable to residue gas derived from new gas-well gas.

Flowing gas includes all gas except new gas-well gas and residue gas derived therefrom.

from the application of the quality adjustments became the applicable area rate for the particular sale in question.

A minimum base area rate of 9 cents per Mcf for all gas subject to quality adjustments was prescribed.

Special treatment was provided for small producers, whom the Commission defined as producers with sales of less than 10 million Mcf of jurisdictional gas per year. They may receive small producer certificates which authorize all future small producer sales in the area at or below the applicable area ceiling rate. They will not have to obtain separate certificates for each sale, or file the normal annual reports required from large producers.

Provision was made by the Commission for an individual producer to obtain special relief from the imposition of the area rates where such a producer could make a proper showing justifying such treatment, but the Commission made clear that it would not allow this provision to become an escape clause to return to individual company rate making.

The Commission ordered a moratorium on the filing of rate increases above the applicable area rate until January 1, 1968.

With respect to Section 4(e) dockets consolidated in the proceedings, the Commission provided for refunds of increased rates collected subject to refund prior to September 1, 1965, in excess of the applicable area rates. Payment of these Section 4(e) refunds was not required, however, until further action by the Commission. (R. 696d)

3. APPLICATIONS FOR REHEARING

Numerous applications for rehearing were filed by the producers. Rehearing was also sought by California (R. 1002d-1026d). On October 4, 1965, the Commission issued

Opinion No. 468-A, denying all applications for rehearing. However, in response to objections made by producers, the Commission modified the quality standards prescribed in Opinion No. 468 by reducing the delivery pressure standard, and by applying the downward and upward Btu adjustments to flowing gas. It also dealt with the producers' contentions that jurisdictional revenues must equal jurisdictional costs. Moreover, with respect to refunds, the Commission made clear that it would not take action requiring payment of refunds until at least review by a Court of Appeals was concluded (R. 1123d).[14]

D. Proceedings in the Court of Appeals

Pursuant to Section 19(b) of the Natural Gas Act, the producers, related producer associations, and the states of New Mexico and Texas, respondents herein, filed in the Court of Appeals for the Tenth Circuit petitions to review Commission Opinion Nos. 468 and 468-A.

California intervened in these review proceedings and took the position that the Commission's decision should be affirmed as a lawful exercise of the Commission's authority under Sections 4 and 5 of the Natural Gas Act to fix just and reasonable rates.

1. THE COURT'S OPINION

On January 20, 1966, the court below stayed Opinion Nos. 468 and 468-A, with certain exceptions, until thirty days after its decision on the merits or until thirty days after

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14. The Commission has not yet issued an order requiring payment of refunds.

the determination of any petition for rehearing.[15] On January 20, 1967, it rendered its decision remanding the proceedings to the Commission for further hearings. On February 1, 1967, the Commission moved for a stay of mandate and suggested the extension of the stay order. The court below, on February 15, 1967, extended its stay order until thirty days after termination of the proceedings in this Court in the event that petitions for writ of certiorari were filed.

The Court of Appeals affirmed the Commission's authority to adopt the area rate method of regulation. Furthermore, it unequivocally rejected the producers' contention that effective competition exists in the natural gas production industry. Instead, it concluded that the Natural Gas Act's standard of just and reasonable rates and *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591 (1944),[16] required consideration of costs and revenues and rejection of the producers' contract-based commodity value approach. However, the court concluded that the Commission failed to comply fully with the legal requirements for rate making under the Natural Gas Act as determined in the *Hope* case and in *Wisconsin v. Federal Power Commission*, 373 U.S. 294 (1963).[17] It also concluded that certain other provisions in the Commission's opinions and orders were vague.

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15. The court below did not stay the provisions of the Commission's decision which require filing of rate reduction supplements, quality statements, and refund reports, but these filings are not to become operative until termination of the stay order. It also ordered the producers to set aside for possible refund all amounts collected subsequent to September 1, 1965, in excess of the rates determined to be just and reasonable.

16. Hereinafter referred to as *Hope*.

17. Hereinafter referred to as *Second Phillips*.

With regard to the question of compliance with the *Hope* and *Second Phillips* cases, the court below held that the Commission had "rejected the end result test and adopted a fair relationship standard." (XII R. 44) It could not ascertain from the Commission's decision the producers' revenue requirements, or the economic factors which permit departure from consideration of costs and revenues, and therefore it could not accept the Commission's determination that a "fair relationship" between costs and revenues was sufficient to comply with the "end result" test. It took the position that under the end result test costs and revenues must balance:

> "Nothing in Second Phillips rejects the end result test of Hope. We believe that it applies here and that it is not satisfied by a finding of fair relationship. . . .
>
> "From the standpoint of the producer the situation is different. It is entitled to recover its prudent operating expenses and capital costs with a return commensurate to the risk and sufficient to attract capital. These requirements must be tested against the record. They may not be brushed aside with a general finding of fair relationship. The Commission concedes that it did not equate jurisdictional costs to jurisdictional revenues. This is obvious because no determination was made of the jurisdictional revenues which the rates will produce." (XII R. 46)

The court ordered that the Commission hold further hearings "to determine group revenues and group revenue requirements," and to make detailed findings to sustain the conclusion of fair relationship. (XII R. 61)

The court disapproved of the manner in which the Commission treated the problem of price deductions for poor quality gas. The Commission decided that the possibility of finding poor quality gas constituted a risk to the producers and that it should be included in the rate-of-return

allowance. The court rejected this position, and held that price deductions to reflect quality deviations are an item of cost and should be quantified and included "in the applicable base rates instead of hidden in a rate of return allowance." (XII R. 54) Only then, the court held, could it review the adequacy of the rate-of-return allowance.

The court found that the Commission's special relief provision was "insufficient and unsatisfactory." This provision indicated that relief would be available for high cost producers who are unable to recover their costs under the applicable area rates. The court agreed with the producers that this relief provision was "so vague and nebulous that neither they nor a court can determine what relief is being granted." It directed the Commission to establish relief provisions which "contain guidelines which if followed by an aggrieved producer will permit it to be heard promptly and to have a stay of the general rate order until its claim for exemption is decided." (XII R. 51)

With regard to the quality standard for heating value, the court did not understand why the Commission decided to have the downward adjustment begin at 1000 Btu and the upward adjustment begin at 1050 Btu. The court directed that the Commission clarify its reasons for this 50 Btu gap between upward and downward adjustments in price. As for the other quality standards the Commission established, the court did not expressly approve or disapprove them. However, it did refuse to resolve the producers' argument that the imposition of them violated procedural due process because of lack of notice, saying: "We are remanding the case and now everyone has notice." (XII R. 52)

2. THE COURT'S PER CURIAM OPINION AND ORDER ON REHEARING

Petitions for rehearing of the Court of Appeals' decision were filed by certain producers. On April 18, 1967, the court

issued a *per curiam* opinion and order on rehearing on the matters of refunds and the certificate order issued concurrently with Opinion No. 468. (XII R. 87-9)

The Court of Appeals reversed its original decision with regard to refunds of rates collected subject to refund under Section 4(e) of the Act. In its original opinion it approved the Commission's decision that individual company refunds were required on a rate schedule by rate schedule basis. The court relied upon *Federal Power Commission v. Tennessee Gas Transmission Company,* 371 U.S. 145 (1962), and said that "refunds are appropriate for each excessive rate regardless of over-all revenues". (XII R. 58) It also noted that an adequate relief provision would take care of any possibility of confiscation resulting from refunds. In its *per curiam* opinion, however, the court below adopted the position of the producers and held that refunds on a rate schedule by rate schedule basis would be inconsistent with its conclusion that in an area rate proceeding group revenues must equal the group revenue requirements. Therefore, the court prohibited any refunds when there is a group revenue deficiency. The court directed that refunds may be ordered "on some equitable contract-by-contract basis" when group revenues exceed the group revenue requirements. In its change of position on this matter the court withdrew its reliance upon *Federal Power Commission v. Tennessee Gas Transmission Company,* 371 U.S. 145 (1962), and relied upon *Second Phillips.*

In addition, the lower court's *per curiam* opinion and order on rehearing apparently remanded the Commission's certificate order issued concurrently with Opinion No. 468. (XII R. 88) The concurrent certificate order concerned four separate applications under Section 7 of the Natural Gas Act for certificates of public convenience and necessity

to sell gas produced in the area.[18] These applications were consolidated with the area rate proceeding and in the meantime temporary certificates were granted to all four applicants. By its concurrent certificate order the Commission granted permanent certificates to these applicants, but it conditioned them to an initial price no higher than the applicable area rates. Upon petition for rehearing by one of the producers, Texaco Inc., in Docket No. CI61-879, the Court of Appeals in its *per curiam* opinion has remanded the concurrent certificate order in the Texaco Inc. matter, Docket No. CI61-879. The court probably intended its opinion and order to include remand of the Commission's entire certificate order. In any event, the lower court expressly declined to either approve or disapprove the Commission's action to constitute the area rates determined under Sections 4 and 5 of the Act to be the initial price required by public convenience and necessity in certificate applications under Section 7. By its action the court refused to approve the position adopted by the Commission.

In all other respects the petitions for rehearing were denied. (XII R. 89)

SUMMARY OF ARGUMENT

The decision of the court below constitutes a major judicial precedent under the Natural Gas Act. Unfortunately, it is obscure and contradictory. The court below misconstrued the requirements for rate making as laid down by this Court in the *Hope* case, and the suggestions relating to area rate making which were made by this Court in the *Second Phillips* case.

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18. The four applications consolidated are: North Central Oil Corporation (Operator), *et al.*, Docket No. CI60-435; Socony Mobil Oil Company, Inc., Docket No. CI61-34; Robert T. Brown (Operator), *et al.*, Docket No. CI61-733; Texaco Inc., Docket No. CI61-879.

Area rate making is not identical to individual company cost-of-service rate making. Neither *Hope* nor *Second Phillips* requires that area revenues must equal area costs. Under these decisions and the Natural Gas Act the Commission may establish rates based upon composite cost data and upon consideration of economic factors other than costs. When the total effect of the rate order is considered, it establishes a fair, if not generous, relationship between the group revenues and allowable group costs of the producers.

With respect to any revenue deficiency resulting from voluntary low contract prices, the Commission is not required to raise these contract prices to the level of its just and reasonable area rates in order to balance area revenues and allowable costs. By suggesting that such an increase is required the lower court has disregarded this Court's decisions in *United Gas Pipeline Company v. Mobile Gas Service Corporation,* 350 U.S. 332 (1956), and *Federal Power Commission v. Sierra Pacific Power Company,* 350 U.S. 348 (1956).

Moreover, the Commission's determination to treat the possibility of finding gas of less than pipeline quality as a risk rather than as a cost is permissible under the Act. Consequently, the utilization of a more than adequate rate of return to provide for the revenue impact of price deductions for deviations in the quality of gas is lawful. The court below has departed from the primary principle of the *Hope* case that "it is the result reached, not the method employed, which is controlling" by directing the Commission to treat quality deviations as an item of cost and not as a risk. Therefore, the generous 12 percent rate of return provided by the Commission should be affirmed by this Court.

The Court of Appeals has erred by ordering that refunds in the consolidated Section 4(e) proceedings must be determined on an area basis. This position is contrary to the policy that refunds under the Natural Gas Act are deter-

mined on a rate schedule by rate schedule basis. Not only is the lower court's decision on refunds contrary to principles laid down by this Court in *Federal Power Commission v. Tennessee Gas Transmission Company,* 371 U.S. 145 (1962), and in *Sierra Pacific* but its effect virtually eliminates any practical meaning to the refund protection provisions of the Act. Such a result is grossly inequitable to consumers.

The court below has failed to make known to the Commission what it must do in order to correct its decision with regard to the "Btu gap" and its special relief provision. Both aspects of the Commission's decision are lawful exercises of expertise by an administrative agency and well within the limits of reasonable discretion. Finally, the Commission's concurrent certificate order should be approved by this Court as the appropriate initial price in the consolidated Section 7 proceedings.

ARGUMENT

I.

The Commission's Decision Fully Complies with This Court's Decision in the Hope Case by Providing a Fair Relationship Between Aggregate Costs and Aggregate Revenues

A. THE COURT BELOW HAS MISCONSTRUED THIS COURT'S DECISION IN THE HOPE CASE WITH REGARD TO RATE MAKING UNDER THE NATURAL GAS ACT

The primary issue in this case is whether the Commission has complied with the legal requirements for rate making under the Natural Gas Act. The Court of Appeals concluded that the Commission failed to do so. After recognizing that "the Commission is not bound by any formula or method" in rate making under the Act, the court concluded that the controlling standard for area rate making is the end result test set down in the *Hope* case. (XII R. 46) It rejected, however, the Commission's determination that the end result test was satisfied by its finding that the total effect of the

rate order, when viewed in its entirety, established a fair relationship between the area rates prescribed by the Commission and the allowable cost of service for the area. The Commission's method involved consideration of composite cost data as a basic ingredient in area rate making as well as other economic and policy factors, but it did not involve a specific finding that group revenues would balance group costs.[19]

The lower court fully adopted the producers' position that once composite cost-of-service data are utilized in area rate making, the Commission must proceed as it would in an individual utility company cost-of-service proceeding. (XII R. 59) Therefore, it concluded that the Commission must, under the end result test, balance area costs and area revenues. (XII R. 44-46; 58-60)

California submits that this position is based on too narrow a construction of the Natural Gas Act and on a mistaken interpretation of *Hope*. It interprets the *Hope* end result test to be extremely rigid and narrow, consisting of nothing more than slavish adherence to a mechanical formula. It completely ignores the principle established in *Hope* that upon review of a rate order issued by the Commission the critical question is whether the rate determination's total effect is fair to the parties concerned. It denies flexibility to the Commission, and it grossly misunderstands the area rate concept by viewing it as no different from individual company cost-of-service rate making.

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19. It should be recognized that "group costs" or "costs," as used herein refer to the Commission's cost-of-service determinations for new and old gas-well gas. These cost-of-service determinations were used as yardsticks for the pricing of other types of gas. They include allowances for exploration which may or may not be expended for this purpose. Certainly the term "costs" does not refer to costs which must be recovered in order to avoid confiscation and consequent denial of due process. (XII R. 49)

1. The Statutory Standard of Just and Reasonable Rates Is Broad and Flexible

The statutory rate making standard in both Sections 4 and 5 of the Natural Gas Act is "just and reasonable." Section 4(a) declares that rates which are not just and reasonable are unlawful, and Section 5(a), the rate investigation section, provides that the Commission shall determine the "just and reasonable rate."

This standard is broad and flexible; no single formula of rate making is required. It does not command traditional rate base cost-of-service regulation, and it does not prevent area rate making. This Court made this point clear in *Federal Power Commission v. Natural Gas Pipeline Company,* 315 U.S. 575 (1942), as follows:

> "The Constitution does not bind rate-making bodies to the service of any single formula or combination of formulas. Agencies to whom this legislative power has been delegated are free, within the ambit of their statutory authority, to make the pragmatic adjustments which may be called for by particular circumstances. Once a fair hearing has been given, proper findings made and other statutory requirements satisfied, the courts cannot intervene in the absence of a clear showing that the limits of due process have been overstepped. If the Commission's order, as applied to the facts before it and viewed in its entirety, produces no arbitrary result, our inquiry is at an end." (315 U.S. 586-7)

It is in the light of the broad and flexible standard of "just and reasonable" that we must look at the *Hope* case.

2. Standards of the Hope Case

Hope was an individual pipeline company rate case. First, this Court enumerated the important principles concerning regulatory method laid down in the *Natural Gas Pipeline Company* case.[20] The Court said:

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20. 315 U.S. 575 (1942).

"We held [citing the Natural Gas Pipeline Co. case] that the Commission was *not bound to the use of any single formula or combination of formulae in determining rates.* Its rate-making function, moreover, involves the making of 'pragmatic adjustments.' And when the Commission's order is challenged in the courts, the question is whether that order *'viewed in its entirety'* meets the requirements of the Act. Under the statutory standard of 'just and reasonable,' it is the result reached not the method employed which is controlling. . . ." (320 U.S. 602; emphasis added.) (Citations omitted.)

Second, the Court announced that review of a rate order requires scrutiny of the total effect or the end result of that order:

"It is not theory but the 'impact' of the rate order which counts. If the *total effect* of the rate order cannot be said to be unjust and unreasonable judicial inquiry under the Act is at an end. *The fact that the method employed to reach that result may contain infirmities is not then important.* . . ." (320 U.S. 602; emphasis added.)

Third, in discussing the regulatory standard of balancing investor and consumer interests, the Court observed:

"The fixing of prices, like other applications of the police power, may reduce the value of the property which is being regulated. But the fact that the value is reduced does not mean that the regulation is invalid. Bloch v. Hirsh, 256 U.S. 135, 155-7, . . . Nebbia v. New York, 291 U.S. 502, 523-539. . . ." (320 U.S. 601)

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"Thus we stated in the Natural Gas Pipeline Co. case that *'regulation does not insure that the business shall produce net revenues'* [citation] . . . The conditions under which more or less [return] might be allowed are not important here." (320 U.S. 603; emphasis added.)

Fourth, the Court also stated the rule regarding scope of judicial review:

> "Moreover, the Commission's order does not become suspect by reason of the fact that it is challenged. It is the product of expert judgment which carries a presumption of validity. And *he who would upset the rate order under the Act carries the heavy burden* of making a convincing showing that it is invalid because it is unjust and unreasonable in its consequences. . . ." (320 U.S. 602; emphasis added.)

Therefore, we may conclude that the *Hope* case means that (1) the Commission can use various formulae or methods in fulfilling its regulatory function under the Act; (2) if, when viewed in its entirety, the *total effect* of the rate order is fair (i.e., just and reasonable) to consumers and the company's investors, the rate order must stand; (3) in balancing the consumer and investor interests regulation is not required to insure net profits; and (4) the burden of overturning the Commission's decision is a heavy one and it must include a convincing showing of unreasonableness.

The essence of the *Hope* end result test is fairness. Upon judicial review, the Court must judge a rate decision by its fairness to the consumer interests affected and to the company's investors.[21] If the result is fair to both, if it strikes a fair relationship between the two, it is just and reasonable.

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21. See also *Colorado Interstate Gas Company v. Federal Power Commission*, 324 U.S. 581 (1946), which involved limited review of a Commission rate order issued after proceedings under Section 5. With regard to allocation of costs and selection of a system peak day the Court affirmed the Commission, noting that "considerations of fairness, not mere mathematics" govern these matters. See 324 U.S. 581; 591, 593.

3. In Applying the Hope End Result Test to Area Rate Making, Which Is Not Identical to Individual Company Rate Making, There Is No Requirement or Sound Reason Why Area Revenues Must Equal the Allowable Area Cost of Service.

The foregoing analysis of the *Hope* case demonstrates that the Commission does not have to use one particular formula or equation, and that the end result test is made by viewing the Commission's order in its entirety to see if it is just and reasonable.

By focusing exclusively on the revenues-costs equation, the court has concluded that only this equation satisfies the end result test, that area rate making must conform exactly, *without any deviation whatsoever,* with individual company cost-of-service rate making: i.e., the revenues produced by the rates must balance the allowable cost of service. It ignores the crucial fact that under area rates some producers will reap a bonanza and those who may require special relief will receive it from the Commission. It also ignores the factors in the Commission's determination of the cost of gas-well gas which are generous to the producers, as well as the various non-cost factors which were considered. When all these facts underlying the rate order are evaluated in their entirety, we submit that its total effect is far from unfair to the producers, and therefore the end result test is satisfied.

That area rate making was going to be more imaginative and less mechanistic than individual company cost-of-service rate making was indicated long before the Commission issued its decision. In 1962, a stern critic of the Federal Power Commission, Mr. James M. Landis,[22] speak-

22. Former member Federal Trade Commission, Securities Exchange Commission, Chairman Civil Aeronautics Commission, Dean Harvard Law School, 1937-46, President's Assistant for Reform of Regulatory Agencies; see Report on Regulatory Agencies to the President-Elect, printed for use of Senate Committee on Judiciary, 86th Cong., 2nd Sess. 1960.

ing to the representatives of the gas industry on the subject of area rate making, warned against making too close an analogy between individual company cost-of-service regulation and area rate making, as follows:

> "Both the initial congressional approach and that of the courts was influenced by concepts derived from years of experience with utility regulation. Fortunately, neither Congress or the Supreme Court has even [sic] said that the pattern of utility regulation must be followed undeviatingly, only that the data which that pattern would bring to the fore are worthy of serious consideration in any eventual conclusion that will be reached. . . .
>
> "A second difficulty arising from the attempt to analogize rate regulation in the natural gas field to that of utility regulation is that the approach in the latter is *always on an individual basis* but it is rarely on a similar basis in the natural gas field.
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> • • •
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> "Indeed, if analogical reasoning is at all applicable in the natural gas field, the analogy that could, perhaps, best have been utilized would have been the techniques employed in the regulation of the price of milk from various milk-sheds or in practices utilized during war time in regulating the price of various commodities. From the standpoint of fairness to the producer, the low-cost producer, even though his low costs may derive from pure luck, should not be deprived of the efforts arising out of his efficiency or the windfall that Lady Luck has granted him; nor should the public be required to compensate the high-cost producer for misfortunes that he may have encountered. This type of speculation is inherent in all private enterprise. *It exists even in the utility field, where Mr. Justice Brandeis sought to refine the concept of original cost by reference to prudent initial investment.* It exists in the airline field, where subsidy is calculated not merely on operational costs but on

those costs as qualified by the concept of honest and efficient management." (13 Institute on Oil and Gas Law and Taxation 407-09; emphasis added.)

* * *

"There are parallels, and there is the possibility of cross-fertilization between the techniques that can be employed in this and other fields." (13 Institute on Oil and Gas Law and Taxation 411)

Nevertheless, the lower court's rigid interpretation of the end result test completely ignores the basic differences between area and individual company rate making.

In Opinion No. 468 the Commission emphasized the superiority of an area approach to determining rates for producers over an individual company approach. It said:

"Basic to this determination is the fact that objective cost standards for fixing just and reasonable rates for producer sales can best be developed by examining overall producer experience. An individual producer may find only dry holes or marginal wells or his search for gas may result in finding a huge new gas field. A price fixed by his individual cost experience could thus either be too high for consumers in relation to other available supplies or too low to be fair to the producer, considering his risks. However, on a group basis, costs and rates can be developed which will be fair to all concerned. A uniform ceiling price for the area will provide *a fair relationship* between the aggregate price the consumer pays and the aggregate costs that the producers incur.

"A uniform area pricing system is adapted to the economics of the natural gas industry. The producer who finds large reserves will achieve greater profits than the producer whose exploration efforts result in dry holes or marginal wells. Likewise, the producer whose enterprise is conducted with efficiency and economy will make more money than the producer who runs

> his business poorly. There is a strong incentive in area pricing to prudence and economy which does not exist in individaul company cost-plus pricing in an industry where individual cost norms are difficult to determine and apply. True, *individual returns will vary greatly, but this is as it should be, provided that profits in the aggregate are at a reasonable level.*" (R. 547d-8d; emphasis added)

The mere fact that *area* revenues do not balance *area* allowable costs does not necessarily mean that the *effect* of the rate order is unfair when it is realized that some individual producers will reap great profits under the area rates while others who may be threatened by losses will be eligible for special relief.

While the lower court is correct when it says "Nothing in *Second Phillips* rejects the end result test of *Hope*,"[23] there is no command in *Second Phillips* that area revenues and costs would have to balance as the pipeline company revenues and costs balanced under *Hope*.

In that case, which at the very least gave the Commission a green light to pursue the area method, the Court said:

> "To whatever extent the matter of costs may be a requisite element in rate regulation, we have no indication that the area method will fall short of statutory or constitutional standards. The Commission has stated in its opinion in this proceeding that the goal is to have rates based on 'the reasonable financial requirements of the industry' in each production area, 24 F. P. C., at 547, and we were advised at oral argument that composite cost-of-service data will be considered in the area rate proceedings. Surely, we cannot say that the rates to be developed in these proceedings will in all likelihood be so high as to deprive consumers,

23. XII R. 46.

or so low as to deprive producers, of their right to a just and reasonable rate.[16]" (373 U.S. 309-10. Footnote omitted.)

Had the Court envisioned that area rate making required strict adherence to a revenue-cost equation, it surely would not have discussed the role of costs in this fashion. California submits that the Commission gave very careful consideration to the words of this Court in *Second Phillips*, describing, or perhaps suggesting is more accurate, the flexibility of the standard to be used in area rate making. That is why, in Opinion No. 468-A, the Commission stated quite frankly that it made no finding that area revenues will equate to the allowable area cost of service. (R. 1114d) It was concerned only with striking a *fair relationship* between them *on an area basis,* not balancing them as in an individual company rate proceeding. The *Hope* case requires fairness to both consumers and investors. California submits that the answer to the Court of Appeals' concern over unbalanced area revenues and allowable group costs lies in a more careful look at the Commission's decision to see if it strikes a fair relationship between these costs and revenues. We believe that a view of the total effect of the rate order will show that the relationship is not only fair to the producers, it is generous.

4. In Rejecting the Commission's Fair Relationship Determination, the Court of Appeals Failed to Consider the Factors Which Make the Total Effect of the Commission's Decision More Than Just and Reasonable.

The court below focused exclusively on the revenues-costs equation. In rejecting the Commission's determination that a fair relationship between area revenues and costs satisfied the end result test, the court emphasized that it was not

told what economic factors "either require or permit departure from costs and revenues." (XII R. 60) In taking this position, the lower court failed to evaluate or even mention the various factors which the Commission said it did consider, such as: (1) that area rate making differs from individual company cost-of-service rate making in that it does not involve the costing of all gas, but instead, the costing of old gas-well gas as the yardstick to set the price for oil-well gas on a commodity value basis because this gas is a by-product of oil production and, as a result, its cost could not be accurately determined (R. 1112d);[24] (2) that some 9.0 cents of the 14.5 cents price for flowing gas was partly based on non-cost factors with the purpose of meeting the producers' "revenue deficiency" argument (R. 1113d); (3) that the producers would receive additional revenues from their gas production efforts than merely those permitted by the Commission's rate because of certain contract provisions and because of the extraction of liquid hydrocarbons (R. 1113d-4d); (4) that the Commission, on rehearing revised the price adjustments for quality so as to substantially reduce the average downward effect of them (R. 1107d-8d; 1115d); and (5) that the Commission took into account that the design of rates should avoid abrupt departures from existing pricing patterns in order to avoid business dislocations (R. 574d). An appreciation of these considerations is essential to an overall evaluation of the fairness of the Commission's rate order. California submits that the lower court's fixation with the revenues-costs equation prevented it from assessing the total effect of the decision viewed in its entirety. We further assert

24. While the cost of oil-well gas could not be determined precisely, the Commission specifically found that its cost was substantially below the cost of old gas-well gas (R. 1112d).

that, in making such an evaluation of the Commission's first determination of area rates, it should be recognized that, in several respects, the effect of the order is more than just and reasonable; it is generous to the producers.

a. The Commission Substantially Increased the Ceiling Rate Above the Examiner's Recommendations.

The Examiner's determination of the ceiling price involved seven categories of gas. The following table illustrates that these ceiling prices of the Examiner, which were higher than California's recommended ceiling rates,[25] are significantly *lower* than the Commission's rates:

	California on Brief Before the Examiner (¢ per Mcf)	Examiner (¢ per Mcf)	California as Revised for Adoption by the Commission (¢ per Mcf)	Commission Decision Texas (¢ per Mcf)
New Gas-Well Gas	13.5	16.75	14.75	16.5
New Residue from New Gas-Well Gas	12.0†	16.75	13.5†	16.5
New Residue from Casinghead Gas	12.0†	15.0	13.5†	14.5
New Casinghead Gas	9.5†	11.0	10.0†	14.5
Old Gas-Well Gas	13.5	13.5	13.5	14.5
Old Residue Gas	12.0†	13.5	13.5†	14.5
Old Casinghead Gas	9.5†	10.0	10.0†	14.5

†California asserted that separate pricing categories for old and new residue and casinghead gas were not justifiable for rate making purposes.

While the Commission reduced the Examiner's ceiling price of 16.75 cents per Mcf for new gas only .25 cents, it

25. It is not correct to assume, as the court below does (XII R. 46), that consumer interests accept without any qualification the Commission's area rates as just and reasonable. California's recommended rates were considerably less than those finally adopted by the Commission, and California petitioned for rehearing before the Commission on no less than six issues, particularly with regard to the very high rate of return. We supported the Commission in the court below because, after thirteen years of a combination of a false start, settlements, and "regulation" by policy statement, the necessity to establish an effective system of producer regulation is of controlling importance. Furthermore, we believe the rates determined by the Commission are within the zone of reasonableness, albeit at the very top of that zone.

raised the price of all three categories of old gas and new casinghead gas by substantially greater amounts.[26] Old gas-well gas and old residue gas were increased from 13.5 cents to 14.5 cents, and new and old casinghead gas were increased from 11 cents and 10 cents per Mcf to 14.5 cents, even though the Commission noted that the costs of casinghead gas and residue gas derived therefrom are "substantially below 14.5 cents."[27]

Due to the fact that 66 percent of the gas produced in the Permian Basin is oil well gas, i.e., casinghead gas and residue gas derived therefrom,[28] the overall effect of the Commission's decision, compared with the Examiner's initial decision, is a substantial increase in price for the producers.

b. Oil Exploration Expenses Were Allowed

The Commission was generous in its 14.5 cent price for flowing gas because it includes the 4.08 cent allowance "for exploration and development expense even though such gas was largely found as a by-product of the search for oil" (R. 1113d). This allowance and the allowance for return of 5 cents per Mcf, totaling 9 cents of the 14.5 cents price, "are based in part on justifications other than cost, and provide ample allowance for the risk that low quality gas in the area may not command the full area price" (R. 1113d).

c. Spraberry Contracts Were Revived

While the Examiner outlawed the Spraberry contracts, the Commission allowed them to remain in effect, thereby providing substantial additional revenues for the producers (R. 1113d).

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26. One category of gas—new residue gas from casinghead gas—was reduced .5 cent per Mcf by the Commission.

27. R. 1112d.

28. R. 139d-140d, 534d, 1112d.

The Spraberry contracts are a type of sales contract used by El Paso in the Spraberry area, a part of the Permian Basin. They cover the sale of casinghead gas to El Paso for production of liquids and residue gas. Payment is on the basis of a percentage of the liquid proceeds and a fixed price for the residue gas. Almost 20 percent of the gas in the Permian Basin is sold under Spraberry contracts.

The Examiner decided to apply his old casinghead gas price of 10 cents per Mcf and his new casinghead gas price of 11 cents per Mcf to old and new gas, respectively, sold under Spraberry contracts, and refused to give any consideration to the liquids produced from the raw gas in determining a price for the gas (R. 252d-3d). The Commission, however, not only increased the Examiner's casinghead price to 14.5 cents per Mcf for both old and new casinghead gas sold at the wellhead, but it revived the legality of the Spraberry contracts, thereby permitting the producers to receive the Commission's price of 14.5 cents per Mcf for residue gas in addition to the "substantial payments for the liquids which the pipelines extract from the unprocessed gas" (R. 1113d).

In addition to the above increase in price, the Commission exposed consumers to the risk of paying for the processing costs of El Paso if these costs exceed its revenues from liquids extracted from the raw gas. The Commission said:

> "There is no evidence in this proceeding that the pipelines' cost of gathering and processing the casinghead gas purchased under Spraberry contracts is greater than the revenues realized by the pipeline from the liquids extracted. As long as the liquid revenues to the pipeline equal or exceed the processing and gathering costs the consumer will be adequately protected by the ceiling here established for residue gas. If the cost of gathering and processing exceeds the pipelines' liquid revenues by an amount which, if added to the

> price paid for the residue gas, would exceed the ceiling price applicable to residue gas of similar quality, and appropriate reductions of the price cannot be negotiated, the purchasing pipeline may petition the Commission for relief pursuant to Section 5(a) of the Act by ordering an appropriate reduction in the price the pipeline pays for such residue gas." (R. 618d-9d)

First, it should be observed that there is no evidence that the pipelines' costs of gathering and processing are not greater than the liquid revenues retained. If they are greater, obviously the consumer is open to the risk of paying such costs in determing pipeline rates. Second, if these costs exceed liquid revenues, the consumer, under the Commission's view of the matter, is left to the initiative of the pipeline company in obtaining relief through private negotiations or action under Section 5(a) of the Act. What motivation the pipelines will have to pursue either of these remedies is at least open to question, if the excess cost of gathering and processing may nevertheless be charged to consumers in determining pipeline rates. Nor is this a speculative risk. In discussing quality agreements, the Commission said in Opinion No. 468-A that "no pipeline need fear that any such agreement will prejudice its claims to its legitimate costs not covered by the agreement" (R. 1110d). Therefore, it appears that consumers are open to the risk of having to pay for any gathering and processing costs which exceed the revenues obtained by the pipeline from the sale of liquids, if the pipelines cannot, or will not, negotiate "appropriate reductions" in the price they have contracted to pay the producers for this Spraberry residue gas.

d. Plant Liquid Credit Was Lower Than Justified

The producers receive revenues from liquids found with natural gas. A liquid credit of 3.10 cents per Mcf for new

gas was prescribed against the total cost of gas because producers can count against their total cost these expected revenues from liquids. Included as a component of that liquid credit is a plant liquid credit of .2 cents per Mcf (R. 589d-90d).

The Commission observed that this plant liquid credit may have been "underestimated." The Commission stated:

> "The producers' comparison of revenues and costs also fails to reflect a substantial amount of revenue which we did not take into account in any way in computing the cost of old gas-well gas, and which we may have underestimated in determining the new gas-well gas price. We refer to the payments received by the sellers of gas-well gas for liquid hydrocarbons extracted from the gas by the pipelines. El Paso points out in its application for clarification that these liquid credits approximate on the average 0.6 cents to 0.8 cents per Mcf in the Permian Basin. This may be contrasted with the plant liquid credit of 0.2 cents based on nationwide statistics used in computing the cost of new gas-well gas and *the absence of any such credit* against costs in the flowing gas computation." (R. 1113d-4d; emphasis added.)

An understatement of the plant liquid credit, of course, overstates the estimate of the cost of new gas.

California maintains that the producers' "revenue deficiency" argument adopted by the court below is absolutely without merit. The Commission's area rates are more than fair to the producers. We believe that they are certainly far above the confiscation level for the producers as a group in light of the facts explained above. Should confiscation threaten a particular producer, special relief will be available. As for any area revenue deficiency resulting from voluntary low contract prices, it need not be balanced. *Federal Power Commission v. Sierra Pacific Power Company,*

350 U.S. 348 (1956) Moreover, the possible deficiency due to quality deductions has been generously provided for in the Commission's allowance for rate of return. (See pp. 43-6, *infra*.)

B. THE COMMISSION IS UNDER NO DUTY TO FIX AREA CEILING RATES AT A LEVEL DESIGNED TO SATISFY A REVENUE "DEFICIENCY" RESULTING FROM CONTRACT PRICES

In requiring that group revenues balance group costs, the court below has disregarded *Federal Power Commission v. Sierra Pacific Power Company,* 350 U.S. 348 (1956). In *Sierra Pacific,* this Court held that voluntarily made rates which are below the just and reasonable rate cannot be raised merely because they are unprofitable. A natural gas company may agree by contract to a rate affording less than a fair return, and, if it does so, it is not entitled to relief by the Commission for its improvident bargain unless such relief is required by the public interest.[29] Despite the fact that the Commission acted to relieve the producers with low contract prices by establishing a minimum rate of 9 cents per Mcf, the court below seems to suggest that the minimum rate must be raised to the ceiling price level in order to make group revenues equate to group costs. Any such action would be directly contrary to the *Sierra Pacific* decision.

Unfortunately, the opinion of the court below is ambiguous on this point. While noting that under *Sierra Pacific* "the producers are not entitled as a matter of right to collect contract rates that are higher than otherwise reasonable in order to offset other rates limited by contract to

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29. 350 U.S. 348, 355. The Commission partly justified its minimum rate order as being in the public interest because its effect on consumers would be *de minimis*. No such finding is possible if the minimum rate is raised to produce 10 million dollars in order to balance the lower court's revenue-cost equation.

below maximum reasonable levels" and that "contract limitations are one of the facts of life for the natural-gas industry" (XII R. 55-6), it expressed concern over the revenue deficiency resulting from these contract limitations, and it noted that in group procedures before the Interstate Commerce Commission (ICC) "revenue from one source may balance that from another." (XII R. 56) The lower court's discussion of this matter ends with the statement that "the controlling question is whether the proper revenue requirements of the area producers as a group can be satisfied with rates having the ceiling and the floor which the Commission has fixed." (XII R. 57) This language suggests that the minimum rate would be rejected or raised if the court concluded that the "proper revenue requirements" were not "satisfied." Significantly, the lower court concluded that it cannot answer this question because the revenue-cost equation has not been provided.

There can be no doubt of the unlawfulness of raising the minimum rate to or near the just and reasonable rate in order to balance group revenues and group costs. There is no duty upon the Commission to increase the prices of voluntarily made contracts to the ceiling level of its just and reasonable rates merely because the contract prices are lower than the ceiling rates and therefore contribute to the imbalance between revenues and costs.

Under the Natural Gas Act rates do not have to be uniform. The producers themselves set the rates initially by executing individual contracts and filing them with the Commission, which then reviews them from the viewpoint of the public interest. *United Gas Pipeline Company v. Mobile Gas Service Corporation,* 350 U.S. 332 (1956). As stated by this Court:

> "To the contrary, by requiring contracts to be filed with the Commission, the Act expressly recognizes

that rates to particular customers may be set by individual contracts. In this respect, the Act is in marked contrast to the Interstate Commerce Act, which in effect precludes private rate agreements by its requirement that the rates to all shippers be uniform, a requirement which made unnecessary any provision for filing contracts." (350 U.S. 338)

* * *

"... the Natural Gas Act permits the relations between the parties to be established initially by contract, the protection of the public interest being afforded by supervision of the individual contracts, which to that end must be filed with the Commission and made public." (350 U.S. 339)

And in *Sierra Pacific* the Court stated that under Section 206(a) of the Federal Power Act, similar to Section 5(a) of the Natural Gas Act, the Commission could find the lower contract rate unjust and unreasonable if it were so low as to adversely affect the public interest by: (1) impairing the financial ability of the public utility to continue its service, (2) casting an excessive burden upon other consumers, or (3) being unduly discriminatory. But the Court clearly stated that the Commission cannot find a rate unreasonable solely because it yields less than a fair return on net invested capital. As we have seen, a natural gas company may agree by contract to a rate affording less than a fair return, and, if it does so, it is not entitled to relief by the Commission for its improvident bargain unless such relief is required by the public interest.

Therefore, if it is correct, as the Court of Appeals maintains, to view area rate making as no different than individual company rate making, the fact that some producers have old, low-price contracts, which result in a revenue deficiency on a group basis, does not justify increasing the Commis-

sion's minimum rate to the same level as its ceiling rates. The producers cannot complain aboue revenue deficiencies which result because some of them voluntarily contracted to sell gas at prices lower than the cost figure determined by the Commission as just and reasonable. The Commission only stated the law when it said:

> "Obviously the Commission cannot allow higher rates to offset 'revenue deficiencies' resulting from producer contract prices below the area ceiling. The Major Producers' own petition states that the 'revenue deficiencies' resulting from these contractual limitations amounts to 0.76 cents per Mcf. It would be contrary to all regulatory principles to permit prices in excess of an otherwise just and reasonable rate for certain purchases merely because other sales had been voluntarily made at below full costs as herein determined." (R. 1114d-5d)

In addition, the Commission's statement is further supported by *Federal Power Commission v. Tennessee Gas Transmission Company,* 371 U.S. 145 (1962), which states that losses in one zone of operations do not justify an illegal gain in another zone.

Nor can the producers complain that the Commission ignored the problem of their voluntarily made contracts at less than the ceiling price; on the contrary, it prescribed a minimum rate as necessary in the public interest. (R. 669-71d) And its minimum rate of 9 cents per Mcf for flowing gas included a 2 cents per Mcf increase over the Examiner's recommended minimum rate of 7 cents per Mcf for casinghead gas. By so doing, the Commission was again generous. It has provided sufficient relief both for very old, low price, natural gas contracts negotiated when gas was an unimportant by-product of oil production, and

for contracts in which the producers had contractually precluded themselves from obtaining an increase in price. Therefore, there is no basis, either legal or moral, for eliminating any revenue deficiencies resulting from these contractual rates which are below the ceiling price.

II.

The Twelve Percent Rate of Return Fully Provides for Both the Revenue Impact of the Quality Deductions and the Need for a Fair Rate of Return

A. IT IS FOR THE COMMISSION TO DETERMINE THE PROPER REGULATORY METHOD TO PROVIDE FOR THE IMPACT OF THE QUALITY DEDUCTIONS

The court below has rejected the Commission's method of providing for the impact of the quality adjustments by permitting a more than adequate rate of return. Contrary to the *Hope* case, the court has determined what method the Commission should use. It has ordered the Commission to treat price deductions for deviations from pipeline quality gas as "an item of cost rather than an item of risk" which "should be directly reflected in the applicable base rates instead of hidden in a rate of return allowance." (XII R. 54)

By directing the Commission how to treat the impact of quality deviations, the lower court has again misconstrued the *Hope* case. Despite the fact that under *Hope* it is the end result, not the method used, which is the standard for judicial review of the Commission's rate orders, the court has disagreed with the Commission's views on the regulatory method to be followed and substituted its own theory and method. Regardless of how the Commission treated the problem of quality deductions, it is the end result which must be considered. *Colorado Interstate Gas Company v. Federal Power Commission,* 324 U.S. 581, 603-4 (1946)

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Certainly the Commission has the expertise and discretion to view the quality problem as a risk.[30] There can be no doubt that in exploring for natural gas there are at least two possibilities: (1) that no gas will be found, and (2) that the gas which is found may be poor in quality. Both these possibilities are unknown until drilling is completed, and therefore it is reasonable to consider both as risks. By holding that price deductions for quality deviations be treated as an item of the cost of production, the court ignores the fact that there was no showing that low quality gas costs any more to produce than gas of pipeline quality, and the fact that the essential processing costs, if expended by producers to bring low quality gas up to pipeline quality are borne by the pipeline purchasers through payment of the ceiling applicable rate. As the body possessing expertise in regulating this industry, the Commission is well within its legal powers to view this problem in the manner it deems best.

The Court of Appeals has mistakenly accepted the position of the producers that the Commission failed to find the "true rate of return," and therefore failed to determine a definite revenue requirement. They alleged that the Commission ignored the meaning and function of return; and that there must be findings on the return "really intended" on the rate base before an additional return allowance for the risk of quality deductions is determined.

California is not aware of any legal requirement that rate of return be itemized. Certainly, neither *Hope* nor *Bluefield Water Works and Improvement Company v. Public Service Commission*, 262 U.S. 679 (1923), require a breakdown of how much return is provided for each particu-

30. The Commission, as well as the Examiner in his initial decision, explained the compelling necessity for quality standards (R. 245d-246d; 645d-647d).

lar risk. And in *Federal Power Commission v. Natural Gas Pipeline Company,* 315 U.S. 575 (1942), this Court indicated that special consideration may be given to the rate of return determination if the risks of the enterprise require:

> "The regulated business here seems exceptionally free from hazards which might otherwise call for special consideration in determining the fair rate of return." (315 U.S. 597)

While the Court agreed with the Commission in that case that no such hazards existed, this language indicates that the Commission approach in Opinion No. 468 is lawful.

B. THE COMMISSION'S TWELVE PERCENT RATE OF RETURN ALLOWANCE SHOULD BE AFFIRMED.

Since the court below concluded that the Commission could not provide for the risk of finding less than pipeline quality gas with a more than adequate rate of return allowance, it refused to consider the question whether the Commission's 12 percent rate of return was sufficient because it could not "determine the amount of return with any degree of certainty." (XII R. 54) The court justified this refusal on the ground that the record failed to disclose the amount of the quality deductions, and therefore it was "impossible to determine whether the rate of return satisfies the Bluefield and Hope principles . . . ." (XII R. 54)

The error of the Court of Appeals is its refusal to consider whether the Commission's very generous rate of return allowance adequately provides for all the risks of the natural gas production industry, including the risk of finding less than pipeline quality gas. California submits that the 12 percent rate of return is fair and reasonable, and fully compensates for risk.

The determination of a 12 percent rate of return, which is the highest return allowance ever given under the Natural Gas Act, must be considered in evaluating the producers' charge made in the lower court that confiscation has resulted because revenues will not balance costs due to revenue deficiencies resulting from the quality deductions.

The Commission declared that its decision was not exclusively a cost calculation, and that the 12 percent rate of return figure was justified only on the basis that it encompassed *all* the risks facing the industry, including that of finding gas of less than pipeline quality. In Opinion No. 468, the Commission expressly announced that the rate of return covered the effects of quality deductions; i.e., the risk of not finding pipeline quality gas:

> "There is another risk in the production operations which our allowance for rate of return in this proceeding must reflect—the risk of finding gas of less than pipeline quality. . . . While we have provided upward adjustments for new gas-well gas with above average Btu content, nevertheless there remains the risk that any gas found can be sold only at an adjusted ceiling price which involves a substantial discount from the ceiling prices for gas of pipeline quality prescribed herein. *Such risk is a special factor that must be considered in establishing the rate of return for the Permian Basin.*" (R. 602d; emphasis added)

In his concurring opinion, Commissioner Black stressed that the quality deductions were "the most important single reason" for this high rate of return:

> "Perhaps the most important single reason for a liberal rate of return allowance in the Permian Basin is that the greater part of Permian gas is substantially below pipeline quality. The Commission has provided for downward price adjustments to reflect these quality differentials with the result that much of the gas sold

> will not command the ceiling prices we have established. The very strong likelihood that the producers will continue to find large amounts of substandard gas is characterized by the main opinion as a risk factor, and I agree that it is appropriate to reflect this special risk in rate of return, which may well be sufficient to justify a return allowance of 12%." (R. 771d-2d, footnote omitted)

Moreover, the lower court's statement that it could not decide the return issue because the impact of the quality deductions was unknown is incorrect. The Commission expressly found that while the record did not permit *exact* quantification of the impact of the quality deductions, there was adequate record support for the conclusion that the quality impact would be in the range of .7 to 1.5 cents per Mcf, reduced by additional revenue for plant liquids and the effect of the Btu adjustments (see R. 746d, 1115d). But the lower court erroneously stated that the only estimates of quality impact were based on the quality statements filed with the Commission pursuant to Opinion No. 468.

The Commission explained at length in its decision denying rehearing that its rate of return allowance was specifically designed to meet the revenue impact caused by the quality deductions:

> "A major argument presented in the several producer applications for rehearing is that, because of the quality adjustments (presumably even as we are modifying them herein), the Commission has not fixed area rates at a level high enough to produce overall revenues which would in the aggregate match producer 'costs.' The argument fails to take account of the fact that the cost of gas-well gas that served as a yardstick for establishing the area rate includes a twelve percent rate of return (amounting to about 5 cents per Mcf) which the Commission expressly indicated was set at

this figure in part (and in the case of flowing gas, where the problem of low-quality gas is more pronounced, in large part) in order to compensate for the risk of finding gas of less than pipeline quality." (R. 1112d)

Quite apart from their concern over the impact of the quality deductions, the producers charged in the court below that the 12 percent rate of return is wholly inadequate. Before the Commission they advocated a rate of return in the range of 16-18 percent. (R. 597d) Upon judicial review they reargued the evidence and contended that their rejected range is correct, and predicted that the Commission's 12 percent will result in disaster for the industry and consumers.[31]

Specifically, they contend that 12 percent fails to cover the unusual risks of the industry—i.e., the risk of dry holes, or noncommercial wells. While the Commission's 12 percent appears high, it is really too small, they argued, because it applies to an understated rate base owing to industry exploration and development failures being expensed, not capitalized. The answer to this argument is twofold. First, the Commission recognized and evaluated the risk of noncommercial wells in making its determination (R. 601d), as well as the risk of finding less than pipeline quality gas. Second, the high book rate of return of the Commission translates into an even higher return on equity, namely 13.5 percent, assuming an equity ratio of 85 percent.[32] This return on equity is 4 percent greater than the national and Permian group's average return, weighted by capitalization,

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31. The producers conceded that the Commission applied the applicable legal principles, embodied in *Bluefield Water Works and Improvement Company v. Public Service Commission*, 262 U.S. 679 (1923), and in *Hope*.

32. See Commissioner Black's concurring opinion. (R. 766d-772d)

of 9.3 percent compiled by the Commission's staff (R. 605d). Thus, the Commission's determination is most liberal.

The producers also complained that the Commission used an earnings period which was unrepresentative and too short. They predicted that the industry will not be able to compete with other industries in attracting capital, and the use of the low earnings period of 1957-1961 will prolong stagnation in the industry. The best answer to this complaint lies in Commissioner Black's concurring opinion to the Commission's decision:

> "Chase Manhattan's group of companies (including Staff's selection) for the entire period 1934-1961 earned 9.44% on average total capital and 10.46% on average equity capital. For the five-year period 1957-1961 earnings on average total capital were 9.56% and 10.44% on average equity capital.
>
> "The First National City Bank figures, which included data for a large number of companies representing total manufacturing and a substantial group (124 in 1961) of petroleum production and refining companies, show for the petroleum companies a return of 9.66% on equity for the entire period 1925-1961 and 10.88% for the five-year period 1957-1961.
>
> "The Fortune study discloses an average of the mean rates of profit on equity for the petroleum industry to have been 8.88% for the years 1957-1961.
>
> "I cite these figures, not in an attempt to establish that the Commission's rate of return determination is erroneous, because I recognize that these statistics are in many respects not comparable and are likely subject to a variety of infirmities which make them inappropriate for the Commission to rely heavily on. My purpose is to indicate my belief that an over-all rate of return allowance of 12% *is very probably a generous one.*" (R. 770d; emphasis added)

California agrees with the above statement that a 12 percent rate of return is more than reasonable to the producers. We think it far too generous.[33] A return on equity of 13.5 percent on the gas portion of the petroleum industry in the Permian Basin, when compared to the 10.88 percent (First National City Bank) and 8.88 percent (*Fortune* study) for the entire industry during 1957-1961, certainly compensates for any adverse effects due to the use of this period. As for the prediction of stagnation, the Commission can easily rectify such a situation, if it ever develops. This complaint is only a cry for greater profits at the consumers' expense.

Rate of return is, most of all, a question of practical judgment based upon complex data, expertise, and discretion. Simply stated, the Commission's rate of return figure covers all the risks confronting the producers *as a group,* including possible price deductions based upon quality deficiencies. Its rate order, using a most generous rate of return to assure an adequate price, conforms to the legal requirements of the statute and the *Hope* case, and therefore does no violation to the Constitution. Since the quality impact was known and since the Commission found it to be reasonable, the court should have resolved the question of the adequacy of the rate of return which was deliberately made generous on this account. California urges this Court to decide this question and to affirm the Commission's determination.

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33. California objected to the 12 percent rate of return in its application for rehearing of Opinion No. 468.

III.

The Commission's Treatment of Refunds Under Section 4(e) Is Lawful and Necessary to Protect Consumers

A. THE REVERSAL BY THE COURT BELOW OF ITS ORIGINAL POSITION ON THE REFUND QUESTION IS ERRONEOUS

No aspect of the Court of Appeals' decision is more foreboding to consumers than its reversal of its original position on the question of the proper basis for refunds in an area rate proceeding. The court originally said that it "saw no escape that refunds be on an individual company basis and on a schedule by schedule basis" and that if confiscation would result or the public interest would be harmed by any refund obligation the answer was an adequate special relief provision. (XII R. 57-8) On rehearing the court completely reversed itself and held that refunds must be made on an area-wide basis. Refunds would now be permitted only if area revenues exceed area costs.

In analyzing the question of refunds, California submits that it is important to recognize that the Commission found that the applicable area rates determined in Opinion No. 468 are the just and reasonable rates for *past,* present, and proposed sales of natural gas to which its order applies. (R. 687d) Further, even though the area rate is based on a fair relationship between area revenues and area costs, the area rate must be applied to each individual contract rate collected in the past subject to refund under Section 4(e) of the Act. Thus, in this sense, the area rate is the lawful rate for each individual producer in the area. It therefore follows that, as the Commission found, past rates collected subject to refund in excess of the lawful rate, i.e., the just and reasonable area rate, must be disallowed and refunded.

As we see it, the lower court's insistence that refund obligations for past rates "must be on a group basis when an area rate is fixed and tested by the end result" (XII

R. 88) is no more than another manifestation of the court's preoccupation with the revenues-costs equation and is, in truth, another aspect of its position that precise balancing is required. The lower court's disposition of the refund question, we submit, is merely a method whereby "revenue deficiencies" resulting from contract limitations can be made up for past periods by the retention of refunds. We have already pointed out that such "deficiencies" need not be provided for in determining the just and reasonable area rates. *Federal Power Commission v. Sierra Pacific Power Company,* 350 U.S. 348 (1956). In rejecting the Presiding Examiner's approach to refunds which was similar to the approach now adopted by the court below, the Commission clearly understood that such an approach would result in granting revenues to make up for contract limitations. The Commission said:

> "We have established just and reasonable ceiling prices for the Permian area, with adjustments from the ceiling prices in the case of gas which deviates from the quality standards we have established. The applicable ceiling price, including any quality adjustments, is the proper price for gas sold under a particular contract. We think it is proper and equitable to require refunds of amounts collected in excess of the ceiling price for gas sold under each contract. This has been our practice in prior proceedings under the Natural Gas Act, and on this record we see no reason, legal or equitable, to fail to return to the wholesale customers the excess sums they have paid. To the extent that any producer receives a lesser amount than our ceilings permit it is because he has agreed to prices which yield that amount or failed to file for a higher rate." (R.673d-4d)

California asserts that the lower court's solution to the refund question virtually eliminates the protection to con-

sumers provided by the refund provisions of Section 4(e). Under the court's approach, if area revenues do not balance allowable area costs, producers with contract rates collected subject to refund above the lawful area rates may keep these revenues, although this result will not help producers whose contracts prevented the collection of rates now found to be just and reasonable. The court's solution obviously rewards the greedy in the name of binding the wounds of the less aggressive. No greater incentive could be provided for filing increased rates and collecting them subject to refund. Consumers will bear the burden of this impact and face retention of refunds by producers as well.

The court's reliance upon *Second Phillips* to justify its change of position on refunds is misplaced. In that case, the Commission did not make any determination of just and reasonable rates for the future under Section 5(a), deciding that the 1954 test year used was too stale for that purpose, and, further, that the individual company cost-of-service method was unworkable for the regulation of independent producers. It terminated the rate investigation. As for a limited number of Section 4(e) cases consolidated with the Section 5(a) investigation, the Commission also terminated these dockets and ordered no refunds. These few consolidated Section 4(e) proceedings related to "locked-in" periods after the test year 1954. The Commission said:

> "The basis of our decision to terminate the dozen Section 4(e) dockets was that the rates filed in those dockets produced less revenues than the cost of service determined in our opinion. The fact that some of these rates are in excess of the average cost of service determined by us is immaterial. Phillips' rates would normally vary greatly because the sales are made at widely separated points and under different conditions, and

there is nothing to show that these rates are discriminatory or preferential. In our judgment there is little or nothing to be gained for the consumer by continuing a complicated proceeding so as to determine just and reasonable rates for Phillips when it is already known that Phillips was not earning its whole cost of service. To conclude, the attempt here to regulate Phillips' rates on an individual company basis has proved cumbersome and inexact. It has demonstrated however, that there is no public interest in continuing the Section 4(e) proceedings, which are largely concerned with past periods. Furthermore, because of the lapse of time, the 1954 cost of service determined by us is not appropriate for the future. The more recent rate increases filed with us have been suspended under Section 4(e), and they will be subject to the new area methods of regulation discussed in our Policy Statement. In this way we can proceed to a more effective and expeditous regulation of the producer sales." (24 FPC 1009)

The principal reason, it is seen, for leaving the increased rates undisturbed was the finding that these rates produced less revenues than the cost of service determined by the Commission. Thus, *Second Phillips* is a revenue deficiency case, where the standard used was the comparison, or balancing, of jurisdictional revenues and jurisdictional costs.

This Court in *Second Phillips* approved the Commission's termination of both the Section 5(a) investigation and the limited number of increased rate proceedings under Section 4(e). The Court said:

". . . Since these increased rates were 'locked in,' their validity for the future was not at issue; the sole question was whether all or any part of the increases had to be refunded by Phillips. Having decided on the

basis of substantial evidence that the increases did not bring revenues up to cost of service, the Commission properly concluded, on the only matter before it with respect to these dockets, that no refund obligation could be imposed." (373 U.S. 306)

In the instant area rate case, however, we are not dealing with revenue deficiencies for past periods. The just and reasonable area rates determined in Opinion No. 468 are based on a fair relationship of group revenues and group costs for the test period. And these rates, unlike the situation in *Second Phillips,* are declared to be the just and reasonable rates for the past and the future. The only revenue deficiency resulting from these area rates is created by contract limitations which do not produce a recompensable deficiency, and the impact of the quality deductions are provided for by the generous allowance of return contained in the rates, again creating no deficiency. Thus, the problem presented by *Second Phillips* does not exist in the instant case.

Therefore, the court below can hardly rely upon *Second Phillips* in these proceedings. Here the Commission has finished its job and determined just and reasonable rates on an area basis. Rates collected in the past which were higher than the appropriate area rates, but which were not made subject to refund under Section 4(e), will properly be retained by the producers. Only prospective rate relief aids consumers insofar as these rates are concerned. Those higher rates collected subject to refund, however, must be refunded on a rate schedule by rate schedule basis if the refund protection provided by the Act is to have any meaning at all.

In relying exclusively upon *Second Phillips* the lower court's terse opinion on rehearing dismisses *Federal Power Commission v. Tennessee Gas Transmission Company*, 371 U.S. 145 (1962), as inapplicable because it dealt with "zone rates" while *Second Phillips* dealt with "locked in" refunds. This distinction is artificial and meaningless; both cases involved review of orders in Section 4(e) rate increase proceedings.

We submit that the court's reliance on *Tennessee* in its initial opinion was not misplaced. The principle that under the Natural Gas Act rate deficiencies are not to be offset by other rate excesses was expressly approved in the *Tennessee* case. That decision announced fundamental principles regarding refunds under the Act, and cannot be brushed aside on its facts. The Court explained the risks undertaken by a natural gas company when it resorts to Section 4(d) rate increases, and it refused to offset some insufficient rates by illegal gains in others:

> "In addition, an analysis of the policy of the Act clearly indicates that a natural gas company initiating an increase in rates under § 4(d) assumes the hazards involved in that procedure. It bears the burden of establishing its rate schedule as being 'just and reasonable.' In addition, the company can never recoup the income lost when the five-month suspension power of the Commission is exercised under § 4(e). The company is also required to refund any sums thereafter collected should it not sustain its burden of proving the reasonableness of an increased rate, and it may suffer further loss when the Commission upon a finding of excessiveness makes adjustments in the rate detail of the company's filing. In this latter respect a rate for one class or zone of customers may be found by the Commission to be too low, but the company cannot recoup its losses by mak-

> ing retroactive the higher rate subsequently allowed; on the other hand, when another class or zone of customers is found to be subjected to excessive rates and a lower rate is ordered, the company must make refunds to them. The company's losses in the first instance do not justify its illegal gain in the latter. Such situations are entirely consistent with the policy of the Act, and, we are told, occur with frequence. The company having initially filed the rates and either collected an illegal return or failed to collect a sufficient one must, under the theory of the Act, shoulder the hazards incident to its action including not only the refund of any illegal gain *but also its losses where its filed rate is found to be inadequate.*" (371 U.S. 152-3; emphasis added)

The Court explained in *Tennessee* the disadvantages in the refund procedure as a protective device for consumers. 371 U.S. 145, 154-5. Further disadvantages are created by the position of the court below. Under its approach, the "deficiency" resulting from low contract prices and the *Sierra Pacific* doctrine would first be eliminated by the accumulated refunds. In other words, the *Sierra Pacific* doctrine would be automatically ignored, if not overruled. The lower court's approach vitiates the protection to consumers provided by the refund provisions of Section 4(e) of the Act. California submits that this approach cannot be permitted to stand.

B. INCREASED RATES OF EACH INDIVIDUAL PRODUCER COLLECTED SUBJECT TO REFUND MUST BE REFUNDED TO THE EXTENT THEY EXCEED THE APPLICABLE JUST AND REASONABLE AREA RATES

California submits that the law and effective regulatory policy require the refund of any increased rates, collected subject to refund, above the applicable area rates. Section

4(a) commands that any rate that is not just and reasonable is unlawful. As we have observed, a "deficiency" in aggregate area revenues resulting from contract prices which are lower than the just and reasonable area rates impose no duty on the part of the Commission to insure that the "deficiency" is made up through the retention by individual producers of rates which exceed the applicable area rate.

The Commission has traditionally dealt with refunds upon an individual producer basis. The Commission's reasons for ordering this approach in lieu of the Examiner's annual group offset proposal are practical and sound:

> "Several fundamental objections preclude adoption of the examiner's proposed method of computing refunds. We think it would result in inequities among wholesale customers as well as among individual producers. If one wholesale customer has been overcharged it is of little comfort to him to know that another customer has received a bargain. Conversely, if one producer has collected excessive amounts, he should not be relieved of his responsibility to return the excess by reason of the fact that some other producer collected too little. Furthermore, the administrative difficulties involved in attempting for each year, and each category of sales, to equate industry revenues with industry expenditures, and to allocate the excess revenues among the purchasers, seem almost insurmountable." (R. 673d)

The Examiner wanted to balance low contract rates with unreasonably high rates collected subject to refund. Why should a producer who has collected excessive amounts on some contracts subject to refund be permitted to keep those excess sums because he or some other producer has collected too little on other contracts? Any such procedure would be unlawful. Since rates are first set by the producers and pipelines through their contracts, low contract rates are not

entitled to be "raised" by the retention of revenues generated by other rates found to be unjust and unreasonable. *United Gas Pipeline Company v. Mobile Gas Service Corporation,* 350 U.S. 332, 341-5 (1956); *Federal Power Commission v. Tennessee Gas Transmission Company,* 371 U.S. 145 (1962). No such relief is provided under the Natural Gas Act. As we have seen, those producers with unreasonably low contract rates may have them raised only under certain circumstances. *Federal Power Commission v. Sierra Pacific Power Company,* 350 U.S. 348, 355 (1956). The provision for a minimum base area rate is an example of this type of relief. California insists that the increased rates collected subject to refund must be refunded if they exceed the applicable just and reasonable rates. Only in this manner can the refund provision of the Natural Gas Act be made effective to protect consumers against unjustified rate increases.

The producers also contended in the court below that the Commission may only order refunds of *rate increases* collected subject to refund under Section 4(e) of the Act. They vigorously denied that the Commission is authorized to require refunds of the full amount of the *increased rate,* collected subject to refund, which exceeds the applicable area rate. The Commission has said that it will require refunds of all amounts collected subject to refund under Section 4(e) in excess of the applicable area rate. (R. 672d, 695d-6d) We urge this Court to affirm the Commission's conclusion.

California believes that the Commission's order is in accord with the statute. Section 4(e) definitely contemplates the determination of the just and reasonable rate, and then a refund of that portion of the entire increased rate which exceeds the just and reasonable rate. Section 4(e) states:

> "Where increased rates or charges are thus made effective, the Commission may, . . . order such natural-gas company to refund, with interest, the portion of such increased rates or charges by its decision found not justified."

The reference to increased rates not justified certainly means the amount of the entire increased rate collected in excess of the determined just and reasonable rate. It is this amount which must be refunded and nothing less. There is nothing in the statute which limits the amount refundable to the rate increase only.

When producers file for increased rates under Section 4(e) of the Act they accept the hazards and risks of the refund procedure. After the suspension period has passed, they may collect more but in the end they may have to refund more than the rate increment collected. In effect, they become trustees for consumers until the just and reasonable rate is determined. Upon that determination, they must refund the entire excess between the collected increased rate and the just and reasonable rate. This approach is fair to both producers and consumers. Producers will thereby be encouraged to file only "good faith" rate increase applications under Section 4(e) of the Act. In this manner the refund problem will be kept in proper proportion.

IV.

The Commission's Special Relief Provision Is Adequate

The decision of the court below is obscure regarding the Commission's special relief provision. The court concluded that the Commission intended to grant relief only from confiscation. (XII R. 51.) Such a conclusion is clearly erroneous. The Commission did not limit the basis for invoking the special relief procedure to claims of confiscation; it specifically stated that "there may be other circumstances

where a producer as a matter of law or in the public interest would be entitled to some relief." (R. 658d) Obviously when the Commission has only begun the task of establishing a new concept such as area rate making, it cannot now foresee all possible relief situations.

This provision was designed to provide notice that relief would be available. For practical reasons, the Commission did not attempt to foresee all the possible factual situations justifying special relief, nor did it spell out in detail what the relief would be. These specifics obviously could be provided when the time for such relief arose. The court below, however, characterized this provision as "inadequate" and said that an adequate relief provision would "contain guidelines which if followed by an aggrieved producer will permit it to be heard promptly and to have a stay of the general rate order until its claim for exemption is decided." (XII R. 51.) In addition, the lower court seems to say that individual costs should be the basis for relief. (XII R. 51.) This position would mean a return to individual cost of service.

In directing that each producer be entitled to a stay from the Commission's rate order, the lower court provides the means to undermine area rate making through numerous stays pending relief. If a stay is authorized the Commission could be deluged with hundreds of petitions for relief. No such right to a stay was required by this Court in the *New England Divisions Case,* 261 U.S. 184 (1923), in which the ICC's rate order became effective immediately, subject to later adjustment if a proper showing was made.[34] As in

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34. In the most recent freight rate divisions case this Court again voiced approval of the ICC's practice of not providing special individual treatment until after competent and reliable evidence demonstrates a carrier's financial needs for such treatment. *Chicago and Northwestern Railway Company v. Atchison, Topeka and Santa Fe Railway Company,* ..... U.S. ....., 18 L Ed 2d 803, 829 (1967).

that case, there is no reason for an automatic stay from area rates; the general rule should prevail that stays will be granted only upon a showing of irreparable injury to the producer concerned. The mere possibility that a producer is entitled to special relief from area rates does not justify the continuance of collecting rates which have been held to be too high. *Federal Power Commission v. Tennessee Gas Transmission Company,* 371 U.S. 145, 151-2, 154 (1962); *United Gas Improvement Company v. Callery Properties, Inc.,* 382 U.S. 223 (1965).

V.

The Btu Gap Is Within the Commission's Discretion

Nowhere is the lower court's opinion more obscure than with regard to quality standards. It specifically required explanation why the Commission provided the "Btu gap" in its quality standard for heating value. (XII R. 53.) But it failed to approve or disapprove the other quality standards. It merely commented that it would not resolve *at this time* the producers' contention that procedural due process was violated because of lack of notice on the matter of quality standards. Such language leaves the Commission in a quandary. Is it supposed to reopen all the quality standards for further hearings and redetermination, or should it just explain at greater length its reasons for the Btu gap? If it fails to reopen all the quality standards for further hearings, the Commission risks a second remand on the notice question. The effect of the lower court's decision is to reverse the Commission on all its quality standards without giving any reasons.

The producers asserted before the Court of Appeals that the quality standards are discriminatory because the two bases for the Btu adjustment (1000 Btu floor before any deduction in price and 1050 Btu ceiling before any addition

to price) creates a "Btu gap" providing consumers with free Btu's. If this is the ground for the lower court's remand, it lacks any merit.

The "Btu gap" aids the producers far more than consumers. In fact, the Commission was generous to the producers; while it found that Exhibit No. 118 (R. 31,323-31,436) revealed the *weighted average* Btu content of Permian Basin gas-well gas to be 1042 Btu's, it allowed price increases for additional Btu's to start at the 1050 Btu level, only eight above the average, but deductions do not begin until the 1000 Btu point, some 42 Btu's below the average. California advocated that there not be any upward Btu price adjustment in order to retain the integrity of a ceiling price system. The Commission's result is hardly a gift to consumers; there will be more price increases under the Btu adjustment than decreases, and the adjustment has been made applicable to flowing gas as well as new gas-well gas. The producers are in no position to complain about the Btu gap.

VI.

The Commission's Concurrent Certificate Order Should Be Affirmed

The Court of Appeals has remanded the Commission's concurrent certificate order on the ground that since this order establishes the area rate, which the court has reversed and remanded, as the proper initial price to be permitted in the consolidated Section 7 certificate proceedings, the certificate order also must be remanded.

California submits that this action reverses the Commission's determination in Opinion No. 468 that the just and reasonable area rates would constitute the initial certificate price, less possible quality deductions, in subsequent Section 7 proceedings. After stating in the certificate order

that the only issue involved is the level at which the initial price should be set, the Commission relied upon its determination in Opinion No. 468 (R. 668d) to prescribe the area rates as the proper initial price in subsequent certificate proceedings. (R. 827d-828d.) Despite the court's disclaimer that it has not decided the question whether the area rates may be constituted as initial certificate prices, the effect of the court's refusal to decide this question is to sever from this proceeding the issue presented by the certificate order. California submits that the court should have affirmed the Commission's determination even though the correct figure for the initial price would not be known due to the remand of its area rate determination.

The court's action in reversing the Commission's determination on this issue without any discussion can only result in further delay in the development of area rate making. Such action is contrary to the primary purpose of the Act, which is to protect consumers. *Atlantic Refining Company, et al. v. Public Service Commission of New York,* 360 U.S. 378 (1959). If the position of the court below prevails, its opinion on this issue would be required before further judicial review would be possible. California submits that this issue is properly before this Court in that the Commission expressed its view on it in Opinion No. 468 and in its concurrent certificate order. California urges that this Court review this issue and affirm the Commission's determination.[35]

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35. A petition for certiorari filed by California is pending before this Court to review a judgment of the Court of Appeals for the Tenth Circuit remanding a later certificate decision where the Commission also conditioned the certificates to provide that the initial rate should be the just and reasonable applicable Permian Basin area rate. *People of the State of California and Public Utilities Commission of the State of California v. Phillips Petroleum Company, et al.*, No. 373, October Term, 1967. See *Phillips Petroleum Company, et al., v. Federal Power Commission,* 377 F. 2d 278 (10th Cir., 1967).

CONCLUSION

The result of the decision by the court below is to overthrow the Commission's time-consuming attempt to establish effective regulation of natural gas producers on an area basis without considering the practical and logical differences between area rate making and individual company rate making. This result can have only dire consequences for consumers who have been waiting almost thirteen years for effective producer regulation. The remand order of the court below, when combined with the risk of a possible second review proceeding, means an unspecified delay, perhaps into the 1970's. To date, no effective method of just and reasonable price regulation of this industry has been enforced. Price uncertainty continues to be the reality—producers do not know what price to which they are entitled, and consumers do not know whether the price they are paying is lawful. Rate increase has been piled upon rate increase without any final determination of just and reasonable rates. Millions of dollars of potential refunds have accumulated and continue to grow. Even now the total amount of refunds due consumers is estimated to be in excess of thirty million dollars ($30,000,000). If another three or four year delay occurs, this amount will be so great that consumers will be told that refunds are not possible because those producers faced with refund obligations will suffer irreparable damage.

While the Commission's first area rate decision is not perfect, it is lawful and fair to both consumers and producers. California prays that the judgment of the United

States Court of Appeals for the Tenth Circuit be reversed, and that all the orders of the Federal Power Commission involved herein be affirmed.

Respectfully submitted,

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Dated: August 24, 1967

(Appendix Follows)

APPENDIX

Appendix

RELEVANT PARTS OF THE NATURAL GAS ACT

Rates and Charges; Schedules; Suspension of New Rates

Sec. 4. (a) All rates and charges made, demanded, or received by any natural-gas company for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges, shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful.

(b) No natural-gas company shall, with respect to any transportation or sale of natural gas subject to the jurisdiction of the Commission, (1) make or grant any undue preference or advantage to any person or subject any person to any undue prejudice or disadvantage, or (2) maintain any unreasonable difference in rates, charges, service, facilities, or in any other respect, either as between localities or as between classes of service.

(c) Under such rules and regulations as the Commission may prescribe, every natural-gas company shall file with the Commission, within such time (not less than sixty days from the date this act takes effect) and in such form as the Commission may designate, and shall keep open in convenient form and place for public inspection, schedules showing all rates and charges for any transportation or sale subject to the jurisdiction of the Commission, and the classifications, practices, and regulations affecting such rates and charges, together with all contracts which in any manner affect or relate to such rates, charges, classifications, and services.

(d) Unless the Commission otherwise orders, no change shall be made by any natural-gas company in any such rate,

charge, classification, or service, or in any rule, regulation, or contract relating thereto, except after thirty days' notice to the Commission and to the public. Such notice shall be given by filing with the Commission and keeping open for public inspection new schedules stating plainly the change or changes to be made in the schedule or schedules then in force and the time when the change or changes will go into effect. The Commission, for good cause shown, may allow changes to take effect without requiring the thirty days' notice herein provided for by an order specifying the changes so to be made and the time when they shall take effect and the manner in which they shall be filed and published.

(e) Whenever any such new schedule is filed the Commission shall have authority, either upon complaint of any State, municipality, State commission, or gas distributing company or upon its own initiative without complaint, at once, and if it so orders, without answer or formal pleading by the natural-gas company, but upon reasonable notice, to enter upon a hearing concerning the lawfulness of such rate, charge, classification, or service; and, pending such hearing and the decision thereon, the Commission, upon filing with such schedules and delivering to the natural-gas company affected thereby a statement in writing of its reasons for such suspension, may suspend the operation of such schedule and defer the use of such rate, charge, classification, or service, but not for a longer period than five months beyond the time when it would otherwise go into effect; and after full hearings either completed before or after the rate, charge, classification, or service goes into effect, the Commission may make such orders with reference thereto as would be proper in a proceeding initiated after it had become effective. If the proceeding has not been

concluded and an order made at the expiration of the suspension period, on motion of the natural-gas company making the filing, the proposed change of rate, charge, classification, or service shall go into effect. Where increased rates or charges are thus made effective, the Commission may, by order, require the natural-gas company to furnish a bond, to be approved by the Commission, to refund any amounts ordered by the Commission, to keep accurate accounts in detail of all amounts received by reason of such increase, specifying by whom and in whose behalf such amounts were paid, and, upon completion of the hearing and decision, to order such natural-gas company to refund, with interest, the portion of such increased rates or charges by its decision found not justified. At any hearing involving a rate or charge sought to be increased, the burden of proof to show that the increased rate or charge is just and reasonable shall be upon the natural-gas company, and the Commission shall give to the hearing and decision of such questions preference over other questions pending before it and decide the same as speedily as possible. [52 Stat. 822 (1938); 15 U.S.C. § 717c]

Fixing Rates and Charges; Determination of Cost of Production or Transportation

SEC. 5. (a) Whenever the Commission, after a hearing had upon its own motion or upon complaint of any State, municipality, State commission, or gas distributing company, shall find that any rate, charge, or classification demanded, observed, charged, or collected by any natural-gas company in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting

such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order: *Provided, however,* That the Commission shall have no power to order any increase in any rate contained in the currently effective schedule of such natural-gas company on file with the Commission, unless such increase is in accordance with a new schedule filed by such natural-gas company; but the Commission may order a decrease where existing rates are unjust, unduly discriminatory, preferential, otherwise unlawful, or are not the lowest reasonable rates.

(b) The Commission upon its own motion, or upon the request of any State commission, whenever it can do so without prejudice to the efficient and proper conduct of its affairs, may investigate and determine the cost of the production or transportation of natural gas by a natural-gas company in cases where the Commission has no authority to establish a rate governing the transportation or sale of such natural gas. [52 Stat. 823 (1938); 15 U.S.C. § 717d]

Construction, extension, or abandonment of facilities; certificate of convenience and necessity; condemnation proceedings

SEC. 7. (a) Whenever the Commission, after notice and opportunity for hearing, finds such action necessary or desirable in the public interest, it may by order direct a natural-gas company to extend or improve its transportation facilities, to establish physical connection of its transportation facilities with the facilities of, and sell natural gas to, any person or municipality engaged or legally

authorized to engage in the local distribution of natural or artificial gas to the public, and for such purpose to extend its transportation facilities to communities immediately adjacent to such facilities or to territory served by such natural-gas company, if the Commission finds that no undue burden will be placed upon such natural-gas company thereby: *Provided,* That the Commission shall have no authority to compel the enlargement of transportation facilities for such purposes, or to compel such natural-gas company to establish physical connection or sell natural gas when to do so would impair its ability to render adequate service to its customers.

(b) No natural-gas company shall abandon all or any portion of its facilities subject to the jurisdiction of the Commission, or any service rendered by means of such facilities, without the permission and approval of the Commission first had and obtained, after due hearing, and a finding by the Commission that the available supply of natural gas is depleted to the extent that the continuance of service is unwarranted, or that the present or future public convenience or necessity permit such abandonment.

(c) No natural-gas company or person which will be a natural-gas company upon completion of any proposed construction or extension shall engage in the transportation or sale of natural gas, subject to the jurisdiction of the Commission, or undertake the construction or extension of any facilities therefor, or acquire or operate any such facilities or extensions thereof, unless there is in force with respect to such natural-gas company a certificate of public convenience and necessity issued by the Commission authorizing such acts or operations: *Provided, however,* That if any such natural-gas company or predecessor in interest was bona fide engaged in transportation or sale of natural gas,

subject to the jurisdiction of the Commission, on February 7, 1942, over the route or routes or within the area for which application is made and has so operated since that time, the Commission shall issue such certificate without requiring further proof that public convenience and necessity will be served by such operation, and without further proceedings, if application for such certificate is made to the Commission within ninety days after February 7, 1942. Pending the determination of any such application, the continuance of such operation shall be lawful.

In all other cases the Commission shall set the matter for hearing and shall give such reasonable notice of the hearing thereon to all interested persons as in its judgment may be necessary under rules and regulations to be prescribed by the Commission; and the application shall be decided in accordance with the procedure provided in subsection (e) of this section and such certificate shall be issued or denied accordingly: *Provided, however,* That the Commission may issue a temporary certificate in cases of emergency, to assure maintenance of adequate service or to serve particular customers, without notice or hearing, pending the determination of an application for a certificate, and may by regulation exempt from the requirements of this section temporary acts or operations for which the issuance of a certificate will not be required in the public interest.

(d) Application for certificates shall be made in writing to the Commission, be verified under oath, and shall be in such form, contain such information, and notice thereof shall be served upon such interested parties and in such manner as the Commission shall, by regulation, require.

(e) Except in the cases governed by the provisos contained in subsection (c) of this section, a certificate shall

be issued to any qualified applicant therefore, authorizing the whole or any part of the operation, sale, service, construction, extension, or acquisition covered by the application, if it is found that the applicant is able and willing properly to do the acts and to perform the service proposed and to conform to the provisions of this chapter and the requirements, rules, and regulations of the Commission thereunder, and that the proposed service, sale, operation, construction, extension, or acquisition, to the extent authorized by the certificate, is or will be required by the present or future public convenience and necessity; otherwise such application shall be denied. The Commission shall have the power to attach to the issuance of the certificate and to the exercise of the rights granted thereunder such reasonable terms and conditions as the public convenience and necessity may require.

(f) The Commission, after a hearing had upon its own motion or upon application, may determine the service area to which each authorization under this section is to be limited. Within such service area as determined by the Commission a natural-gas company may enlarge or extend its facilities for the purpose of supplying increased market demands in such service area without further authorization.

(g) Nothing contained in this section shall be construed as a limitation upon the power of the Commission to grant certificates of public convenience and necessity for service of an area already being served by another natural-gas company.

(h) When any holder of a certificate of public convenience and necessity cannot acquire by contract, or is unable to agree with the owner of property to the compensation to be paid for, the necessary right-of-way to construct, operate and maintain a pipe line or pipe lines for the transportation

of natural gas, and the necessary land or other property, in addition to right-of-way, for the location of compressor stations, pressure apparatus, or other stations or equipment necessary to the proper operation of such pipe line or pipe lines, it may acquire the same by the exercise of the right of eminent domain in the district court of the United States for the district in which such property may be located, or in the State courts. The practice and procedure in any action or proceeding for that purpose in the district court of the United States shall conform as nearly as may be with the practice and procedure in similar action or proceeding in the courts of the State where the property is situated: *Provided,* That the United States district courts shall only have jurisdiction of cases when the amount claimed by the owner of the property to be condemned exceeds $3,000. [52 Stat. 824 (1938); 15 U.S.C. § 717f, as amended.]

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IN THE

Supreme Court of the United States

October Term, 1967

NOS. 90, 95, 98-102, 105, 117, 181, 261, 262, 266, 388

THE PERMIAN BASIN AREA RATE CASES

On Writs of Certiorari to the United States Court of Appeals for the Tenth Circuit

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BRIEF FOR MOBIL OIL CORPORATION AND NORTHERN NATURAL GAS PRODUCING COMPANY

OPINIONS BELOW

The opinion of the Court of Appeals (XII R. 15-61[1]), as well as its opinion on rehearing (XII R. 87-89), are

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1. The following system will be employed in citing to the 14-volume record in this Court: "R. 1 - R. 1908" - Volumes I - V (testimony); "R. 1e - R. 1146e" - Volumes VI - VIII (exhibits); "R. 1d - R. 1157d" - Volumes IX - XI (pleadings, orders and opinions in the administrative proceedings); "XII R. 1 - XII R. 90" - Volume XII (proceedings in the Court of Appeals and this Court); "R. 1s - R. 40s" (supplemental volume). The remaining volume is a table of contents for Volumes I - XI.

reported at 375 F.2d 6 (10th Cir., 1967). The opinions and orders of the Federal Power Commission (R. 516d-826d, 827d-838d, 37s, 1105d-1132d and 1133d-1136d) are reported at 34 F.P.C. 159, 418, 424, 1068 and 1082 (1965). The opinion of the Commission's Hearing Examiner (R. 97d-364d) is reported at 34 F.P.C. 306 (1965).

JURISDICTION

The judgments of the Court of Appeals were entered on January 20, 1967. (XII R. 62-83). An order on rehearing, modifying the judgments, was entered on April 18, 1967. The petitions for certiorari in Nos. 90, 95, 98-102, 105, 117 and 181 (*Continental Oil Company v. Federal Power Commission; Superior Oil Company v. Federal Power Commission; New Mexico v. Federal Power Commission; Sun Oil Company v. Federal Power Commission; California v. Skelly Oil Company; Hunt Oil Company v. Federal Power Commission; Pacific Gas and Electric Company v. Skelly Oil Company; Bass v. Federal Power Commission; Federal Power Commission v. Skelly Oil Company; City of Los Angeles v. Skelly Oil Company*) were filed previously to and granted by this Court on June 12, 1967. (XII R. 89-90). Mobil Oil Corporation and Northern Natural Gas Producing Company (Mobil) are respondents in Nos. 100, 102, 117 and 181. Since the above listed petitions were granted, petitions for certiorari in Nos. 261, 262, 266 and 388 (*City and County of San Franciso v. Skelly Oil Company; City of San Diego v. Skelly Oil Company; Standard Oil Company v. Federal Power Commission; Mobil Oil Corporation v. Federal Power Commission*) have been filed but not acted upon by this Court. Mobil is petitioner in No. 388 and

a respondent in Nos. 261 and 262. As to those questions presented by Mobil in No. 388, the petition for certiorari states that the briefing schedule prescribed by this Court in the June 12, 1967 order would be followed. In its brief to this Court, filed by August 25, 1967, the Federal Power Commission has responded to the questions raised by Mobil as petitioner in No. 388. This brief is therefore filed by Mobil as petitioner in No. 388 and as respondent in Nos. 100, 102, 117, 181, 261 and 262. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1) and Section 19(b) of the Natural Gas Act, 15 U.S.C. 717r(b).

STATUTES INVOLVED

The pertinent provisions of the Natural Gas Act, 15 U.S.C. 717-717w, are reproduced in the Appendix of the Brief for the Federal Power Commission, which has previously been filed with the Court, and are incorporated herein by reference.

QUESTIONS PRESENTED

The Federal Power Commission has determined what it considers to be those just and reasonable rates which independent producers may charge for natural gas sold in the Permian Basin. Mobil has petitioned the Court for review of four questions regarding the Commission's determination. Numerous other questions are presented in the various petitions for certiorari in which Mobil is a respondent. The questions which Mobil presents are as follows:

1. Whether the Federal Power Commission, bound by a just and reasonable standard may lawfully impose

a system of rates based on classifying natural gas as "new" or "old" according to the date of execution of gas sales contracts, and impose lower rates for "old" gas.

2. Whether, in proceedings determining just and reasonable rates under the Natural Gas Act, the Federal Power Commission may impose a moratorium prohibiting the future filing under Section 4 of the Act of contractually allowable rate increases, thus barring hearings to determine the justness and reasonableness of such increased rates.

3. Whether the Federal Power Commission may forbid rate increase filings under Section 4 of the Act based on price-changing provisions in producer contracts considered by the Commission in previously issued certificates authorizing the sale of gas under these contracts.

4. Whether in compiling composites of group costs used to determine producers' "revenue requirements" and to prescribe area rates under Sections 4 and 5 of the Natural Gas Act, the Federal Power Commission may exclude from such composites the costs incurred by the producing industry in gathering and processing natural gas for sales to pipeline purchasers.

The principle questions presented by those petitions in which Mobil is respondent may be outlined as follows:

1. Whether the Federal Power Commission, in determining maximum area rates for the Permian Basin may adopt only a 12 percent rate as the fair rate of return on production investment and whether after allowing only a 12 percent return the Commission may fail to allow a recovery of that rate on production investment by allowing additional impacts on the rate which lower it from the 12 percent level.

2. Whether the Federal Power Commission, in determining maximum area rates as the industry revenue requirement in the Permian area may justify only a 9 cent minimum from the record before it when consideration is given to the fact that the Commission should design rates within the framework of the Natural Gas Act which will allow a return of those revenue requirements.

3. Whether the Commission, in determining maximum rates applicable to all producers within a producing area, must provide an exemption from the maximum which allows producers specific and individual relief in the form of higher than average rates where maximum rates are confiscatory.

4. Whether the Commission may require refunding of amounts previously collected under permanent certification where a producer has filed for a contractually allowable rate increase above this "last clean rate" and the applicable area rate is determined to be at a level below that previously certified.

5. Whether this Court may properly consider the holding by the Commission that the applicable area rate should be automatically applied in an initial certification under Section 7.

STATEMENT

In 1954 this Court determined that the Federal Power Commission has jurisdiction over the sale of natural gas by producers to interstate pipelines. The decision in *Phillips Petroleum Company v. Wisconsin,* 347 U.S. 672 (1954) (*Phillips I*), thrust upon the Commission regulatory responsibility over thousands of natural gas sales by producers. Having gained *expertise* in regulating interstate

pipelines since the inception of regulation under the Natural Gas Act in 1938 by use of the individual rate base—cost of service method of regulation, a common method used to rate regulate public utilities, the Commission attempted to regulate producer sales by the same method. By 1960 the Commission was ready to concede that producers of natural gas could not be classified as typical public utilities by reason of vastly differing characteristics. Consequently, the Commission concluded that the rate base—cost of service method of regulation, developed in the context of public utility regulation, was unworkable in rate regulating producer sales and proposed that in the future producer sales be regulated on an area rather than an individual basis. This Court in *Wisconsin v. Federal Power Commission,* 373 U.S. 294 (1963) *(Phillips II),* approved the Commission's actions in terminating the then pending individual company rate investigations and instituting area rate hearings. This Court noted the complications which had been encountered in previous attempts at producer regulation by the Commission and expressed the hope that the *results* of the area rate *method* would satisfy constitutional and statutory standards applicable to the Commission and its orders.

The present proceeding before this Court is a review of the *results* of the Commission's first area rate determination. The decision of this Court in these proceedings will influence and determine the course of producer regulation for many years. It is the most important Commission decision to reach appellate review since this Court charged the Commission with the duty to regulate producer sales in *Phillips I.* It is incumbent upon this Court to render a clear and concise decision to assure some semblance of stability and direction in producer pricing and regulation under the Natural Gas Act.

The Commission instituted this proceeding in 1960 to establish just and reasonable rates for interstate sales by producers in the Permian Basin of western Texas and southeastern New Mexico. The area accounts for around 11 percent of all natural gas that moves in interstate commerce and primarily serves the California market. Extended administrative hearings were held before a Commission Hearing Examiner, who issued his initial decision in 1964. On review of the Examiner's decision, the Commission issued its decision and orders prescribing area rates for the Permian Area in 1965. Various producers perfected appeal for judicial review by the Court of Appeals for the Tenth Circuit, which issued an opinion in early 1967 sustaining in part and setting aside in part the decision of the Commission. Subsequently, producers, the Commission and distributor interests petitioned this Court requesting writs of certiorari be granted to review the decision of the lower court. The petitions were granted and the cases consolidated. This Court directed that briefing and oral argument be divided as to those supporting and those opposing the Commission's decision. Mobil urges that certain portions of the Commission's decision be reversed by this Court.

1. THE COMMISSION'S PERMIAN DECISION.

After almost two years of hearings, which produced a transcript of over 30,000 pages and which involved some 384 parties representing producers who were made respondents in the hearings, and numerous affected distributor and consumer groups, the Examiner issued his decision on September 17, 1964. (R. 97d-364d). The Commission issued its decision on August 5, 1965. (R. 516d-826d).

a. *The area approach.*

The Commission determined that it had statutory and constitutional authority to determine producer rates on an area basis as opposed to individual rate determination. This decision was based primarily on the characteristics of the producing industry as the Commission interpreted them. In so concluding, the Commission compared its area method to other area methods of rate regulation employed by Federal regulatory agencies, primarily in the fields of transportation and communications. The Commission also interpreted this Court's decision in *Phillips II* as authority for its attempt at determining just and reasonable producer rates on an area basis. (R. 541d-552d).

b. *The two-price system.*

The Commission concluded that the record before it indicated that the producing industry now possesses the ability to direct exploratory activities toward either oil or gas reservoirs. From this conclusion the Commission determined that a two-price system of area rates should be adopted, since a higher rate was justified for recent and future gas discoveries than that allowed for gas already discovered and flowing in order to induce exploration for adequate supplies of gas for the present and future consumer. The division date between the two classes of gas was set at January 1, 1961, a date which the Commission felt was near the time "directionality" became widespread in the industry. (R. 563d-572d).

c. *The basis of the area rates.*

The Commission held that the maximum area rate applicable to gas well gas (gas not produced in association with oil) in the Permian Area contracted to interstate

sales subsequent to January 1, 1961 (termed new gas), should be determined on a nationwide basis from averages of certain items of cost incurred in association with the production of gas. The rate for new gas well gas was based primarily on averages of nationwide statistics representing what the Commission felt were the current costs of finding and producing natural gas. (R. 572d-577d). In so concluding, the Commission rejected producer contentions that producer contract rates should be the basis for determining just and reasonable rates. (R. 552d-558d). The Commission also refused to adopt a reserves to production ratio as a regulatory standard. (R. 558d-563d). The rate for old gas well gas, that contracted to interstate sale prior to January 1, 1961, was determined primarily on the basis of the historical costs of gas well gas in the Permian Basin. (R. 624d-639d). Again, the Commission based the rate on various cost items incurred in producing gas. Further, the old gas well gas rate was made applicable to all casinghead gas (gas produced in association with oil) and all residue gas (gas remaining after gas well gas or casinghead gas is processed to remove liquid hydrocarbons), except residue gas derived from new gas which was given the same higher rate as new gas. (R. 615d-624d).

d. *The rates prescribed.*

Using nationwide cost, the Commission determined that the averages of the various included cost items justified an area rate for new gas of 16.5 cents per Mcf (thousand cubic feet of gas), including taxes, in the Texas Permian Area and 15.5 cents, plus tax, in the New Mexico Permian Area. Using the historical Permian costs, all other gas, termed flowing gas (old gas well gas, residue gas and casinghead gas) was priced at 14.5 cents, including tax, in Texas, and 13.5 cents, plus taxes, in New Mexico. (R.

570d-572d, 688d-689d). Having prescribed maximum area rates, the Commission also concluded that all producers, both in the New Mexico and Texas Permian Area, should be allowed to make unilateral filings for a 9 cent per Mcf minimum rate, even if the applicable contract specified a lower rate. (R. 669d-671d).

e. *Quality deductions from the rates prescribed.*

Having determined maximum and minimum area rates, the Commission's order provides that the applicable area rate which a producer will be allowed is to be determined by deductions from or additions to the maximum area rates, and deductions from the minimum area rate reflecting deviations from a pipeline quality standard set by the Commission for interstate gas. The standards reflect the carbon dioxide, hydrogen sulfide, sulphur and water content of gas plus its pressure and heating value. The amount of the deduction from the maximum rate is to be measured by the pipeline purchaser's cost of bringing producer's gas up to pipeline quality. The precise extent of these specific deductions was unknown at the time of the decision. In regard to heating value (BTU), pipeline quality gas was determined to be that gas having between 1000-1050 BTU's per cubic foot. Proportional upward or downward adjustment for the maximum rate was prescribed for gas outside this range and made applicable to all gas. (R. 645d-656d, 1108d). The quality standards were also made applicable to minimum rates. (R. 671d).

f. *Rate of return.*

In computing the maximum area rate for both new and flowing gas, the Commission adopted a 12 percent rate

of return which was to reflect, in addition to being a return on production investment, the "risk of finding gas of less than pipeline quality" in the Permian Basin (R. 614d, 633d), and the need for current funds to finance future exploration. (R. 633d).

g. *Special exemption from the applicable area rate.*

In framing the limits of the exemption provision the Commission was clear in noting that it was not dealing with sales to be certificated after the date of its decision. However, the Commission did note that its decision has a double impact on gas presently being sold interstate: the future price of that gas and the amount to be refunded for the past sale of that gas. The Commission provided the outline of a procedure for exemption from the applicable area rate for aggrieved producers, noting that where producers who have *contracted* for "an above ceiling price" can show out-of-pocket expenses in connection with the operation of a particular well above revenues received from the applicable area rate (the maximum less or plus quality standards), the Commission will grant "appropriate relief." The Commission also noted that there may be other situations where "appropriate relief" should be granted. "Appropriate relief" was further defined to indicate that in most cases "it may be sufficient to permit them [producers] to abandon their unprofitable sales." In relation to a refunding of amounts collected in the past above the applicable area rate, whatever that rate, the Commission noted that a producer should not be required "to make refunds for past periods [not defined] which would deprive him of amounts sufficient to cover his out-of-pocket operating expenses in the Permian Basin for such period." The Commission refused to speculate further "as to the exact circumstances in which special relief may be

warranted" and held that until relief was granted a producer would be bound to continue service at the applicable rate. (R. 656d-660d).

h. *The moratorium on rate increases.*

The Commission imposed an absolute moratorium on the filing of contractually allowable rate increases above the applicable maximum rates until January 1, 1968. To avoid the moratorium, a producer must reopen the area proceeding to allow consideration of modifications. The Commission reserved the right "in its discretion" to reopen for moratorium modification. A primary justification for the moratorium was that costs, concluded the Commission, would remain stable from the 1960 test year that forms the basis of Permian rate calculations. (R. 660d-669d).

i. *Permanent prohibitions of certain pricing clauses.*

With respect to Section 4 rate increase filings based on certain flexible pricing clauses in existing contracts, which the Commission found to be objectionable, filings for a contractually allowable rate increase above the applicable area rate were permanently prohibited. Filings based on such clauses were approved up to the applicable area rate. (R. 682d-683d).

j. *Refund of amounts above the area rates.*

Regarding rates that have been collected subject to refund under Section 4 (e), the Commission ruled that it would require refunds of the difference between the applicable area rate (maximum rate adjusted for quality standards) and the amount previously collected under the increased rate. Refunding would be only for the period that the increased rates have been in effect but

would include both the Section 4(e) increase as well as that portion of the rate collected prior to the increase filing which may be above the applicable area rate and which has been collected since the increase filing. (R. 672d-675d). The Commission previously commented on the possible application of the exemption provisions to these refunds. (R. 569d-660d).

k. *Small producers.*

The Commission determined that any producer whose annual sales subject to the Commission's jurisdiction were less than 10 million Mcf of gas per year should be classified as a "small producer." The Commission further determined that the area rates should be applicable to small producers, but without downward adjustment for gas of less than pipeline quality. The Commission further instituted a rulemaking procedure to simplify Section 7 applications by small producers (certificates of public convenience and necessity) and relieve annual reporting requirements. (R. 675d-682d). However, if a small producer wishes to take advantage of upward BTU adjustment for a particular sale, all other quality standards are applicable to the sale. (R. 675d).

2. THE DECISION OF THE TENTH CIRCUIT.

Following the Commission's refusal to alter the basic principles of its Permian decision, numerous producers, along with the States of Texas and New Mexico, filed petitions to review the Permian decision and accompanying orders. On January 20, 1966, the Court of Appeals for the Tenth Circuit stayed the application of the Permian orders insofar as they require rate reductions and refunds. (XII R. 12-14).

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The Tenth Circuit found that the Commission did have constitutional and statutory authority to attempt to determine producer rates by use of an area method. (XII R. 31-38). It upheld the Commission's adoption of a two-price system and the chosen division date. (XII R. 38-40). The Court refused to question the Commission selection of cost information used in setting the applicable area rates. (XII R. 40-41). The Commission's moratorium on Section 4 rate increase filings was approved. (XII R. 43-44). However, the Court refused to either approve or reject the Commission's order regarding the filing for rates above the applicable area rate based on certain escalation clauses reserving a decision until a producer sought waiver of the ban and was rejected. (XII R. 44). The Court felt that the Commission had adopted a "fair relationship standard" for reviewing administrative rates as opposed to the "end result" test previously approved by this Court. (XII R. 44-46). The Commission treatment of small producers was approved and the Court observed that the problem of high cost producers was inherent in any system of area regulation, but that "the impact of the Permian rates on the high cost producers does not destroy the area rate method." (XII R. 46-49).

In relation to gathering and processing costs, and the Commission's allowance of the same rate for gas delivered at the tailgate of a processing plant after gathering and processing as that allowed for gas sold at the wellhead before gathering and processing, the Court regarded allowance of such an element of individualization which should not be allowed in an area proceeding, noting further that if disallowance of such was confiscatory, relief should be granted individually. (XII R. 49-50). The Court found the special exemption provisions "so

vague and nebulous that neither they [Commission] nor a court can determine what relief is being granted." (XII R. 50-51). In passing on the legality of the quality standards and their effect on the applicable area rate, the Court refused to rule on producer contentions that imposition of the standards was without notice and violated due process since "We are remanding the case and now everyone has notice." The Court further noted that the exact impact of the quality standards on the maximum area rates was unknown and that it did "not understand the Commission's reasons" for the 50 BTU gap in lowering or raising price. (XII R. 51-53).

Turning to the rate of return allowed, the Court was not persuaded by the Commission's reasoning that the possibility of finding gas of substandard quality which would receive a price much lower than the maximum area rate had been "taken care of" in determining the allowable rate. The Court held that by treating the impact of quality deductions as a risk instead of a cost, and given the unknown impact of the quality deductions, "the Commission has made it impossible to determine the amount of return with any degree of certainty", and that since producers were already burdened with the risk of discovery gas "The Commission has here compounded the risk of discovery with the risk of substandard quality." (XII R. 53-54). The Court felt that the price reductions to reflect quality deviations should be an item of cost rather than a risk factor, since about ninety percent of Permian gas is substandard (XII R. 52) and "should be directly reflected in the applicable base rates instead of hidden in a rate of return allowance." (XII R. 54).

Regarding contract limitations that would preclude producers from receiving the applicable area rate and the

imposition of a minimum rate, the Court agreed with the Commission that "contract limitations do not preclude the establishment of a just and reasonable area rate." However, the Court refused to pass on the legality of the 9 cent minimum since it felt the controlling question was whether the revenue requirements of Permian producers "as a group can be satisfied with rates having the ceiling and the floor which the Commission has fixed." Because of the absence of the impact of quality deductions in the record, this could not be ascertained. (XII R. 55-57). The Court could see "no escape" from ordering refunds on an individual basis for those rates being collected subject to Section 4(e) rate increase filings which were above the applicable area rate. But the Court directed that producers be heard on any confiscation issue raised by refunding, and similar treatment must be allowed if refunds are to be below the "last clean rate" (permanently certified rates previously in effect not subject to refund). (XII R. 57-58).

And finally, noting that "The Commission held that its ceiling provided a 'fair relationship' between consumer prices and producer costs", the Court felt that this was not complete satisfaction of the "end result" test which this Court has previously prescribed in judging regulatory results. The Court felt that the "end result" test could not be satisfied by reliance on unknowns as the Commission had done in its Permian decision. Specially, the Court found that the unknown impact of the quality deductions prevented the Commission from finding that the proposed area rates would provide producers, as a group, "their prudent operating expenses and capital costs with a return commensurate to the risk and sufficient to attract capital." (XII R. 60). Therefore, the Court held that the

"cases must be remanded because the actions of the Commission do not comply with the end result test established in *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 602-603, and other decisions." (XII R. 22).

On rehearing, the Court altered its refund ruling, concluding that no refund obligation could be imposed for a period in which there was a "group revenue deficiency" and that the amount of refund must be considered in balancing group revenues and requirements. (XII R. 88-89). The Court further refused to rule on whether an area rate established in a Section 5 proceeding automatically becomes an in-line rate for a Section 7 initial certification proceeding and new gas being sold interstate, noting that the principle may be affected by the final validity of the Permian area rate. (XII R. 88-89).

SUMMARY OF ARGUMENT

These consolidated cases bring before this Court the questions surrounding the legality of the results of the Federal Power Commission's first area rate proceeding. The proceeding has determined what the Commission considers to be just and reasonable rates for the Permian Basin area and has devised and applied the method by which those rates are to be made applicable to producers in the area. Mobil does not attack the authority of the Commission to determine producer rates by an area method. Mobil does attack certain of the results which the Commission's area method has produced. This summary is divided into those points which Mobil raises as petitioner and into those points which Mobil answers as respondent.

As Petitioner, Mobil presents to this Court four issues. First, Mobil questions the decision by the Commission to adopt a dual pricing structure with a lower maximum applicable to older gas than to newer gas since such a structure ignores the basic industry characteristic that gas is sold for its present value as energy; ignores the fact that funds for future exploration are generated from current revenue; ignores the fact that new gas reserves can be developed under old reserves previously committed to interstate service; ignores the fact that by its own admission the cost of replacing old gas is higher than the revenues received from such old gas; and raises the specture that old and new gas prices may be lowered in the future thus defeating financial expectations where gas is committed interstate on the basis of present area ceilings.

As second and third points, Mobil as Petitioner questions the statutory authority and reasonableness of the Commission's actions in imposing a moratorium on all increased rate filings above the maximum area rates for a specified period of time and in permanently prohibiting rate increase filings based on flexible pricing clauses since such actions are not justifiable by reason of the specific rate changing and refund provisions of the Act giving natural gas companies the option to file for contractually allowable rate; are not justifiable in that existing contract rate structures which have formed the basis for commitment of gas to interstate sale are disrupted thus destroying previously approved contracts; and are not justifiable when such action destroys the only means by which an aggrieved producer may exempt himself from the applicable area rate.

And, as a fourth point, Mobil as Petitioner questions the Commission in excluding gathering and processing

costs from the various items whose averages were used to cost both old and new gas. Had these same costs been incurred by a jurisdictional pipeline, they would have been included in the pipeline's rate base and cost of service and passed to consumers. The Commission in its determination of both old and new gas provided the same price for gas sold interstate at the wellhead prior to gathering and processing as for that sold after gathering and processing are completed and the selling producer burdened with such costs. Such costs are a legitimate and reasonable cost of producers who must gather and process to sell their gas. The average cost of gathering and processing on either a nationwide or area basis should have been determined from the record before the Commission and this item of cost included.

As Respondent, Mobil answers the various Briefs submitted in support of the Commission's decision by the following points.

First, the Commission has failed to allow a rate of return which is in keeping with the previous decisions of this Court. In allowing only a 12 percent rate of return on production investment the Commission has failed to consider those characteristics which set the industry apart from not only the pipeline industry but other service industries. However, even considering the 12 percent level, because of the impact of the quality deductions as well as the allowance in the flowing gas rate for generation of funds from current revenue for future exploration the producers will not earn the 12 percent rate. This clearly indicates that revenue requirement will not be recovered and by the Commission's own standard the end results of the Permian area method are unjust and unreasonable.

Second, the Commission has determined that a minimum rate should be allowed, but has set a minimum rate which will not provide an opportunity for recovery of the revenue requirements which the Commission has determined for the Permian area.

Third, Mobil as Respondent questions the adequacy of the exemption provision which the Commission has included in the Permian decision both as being too general in not specifying in more detail the individual relief which a producer faced with confiscation may obtain and in suggesting relief through abandonment. Previous comment has been made as to the effect that the moratorium and the ban on flexible pricing clauses will have on the exemption provisions. Abandonment provisions and exemption provisions serve two differing purposes in regulatory schemes and the Commission has erred in confusing them. Further, the Commission should be required to stay the effectiveness of the applicable area rate pending determination of the question of confiscation. Otherwise, the rates requested will be lost irrevocably to the aggrieved producer.

Fourth, Mobil questions the statutory authority of the Commission to use the just and reasonable standard of Section 4 to require refunds below a rate level previously permanently certified by the Commission under Section 7. The refund obligation of Section 4 properly extends only to the increase above the "last clean rate" since once a rate level is permanently certified by the Commission, it may only be altered by Section 5, which only has prospective effect.

Fifth, because of the Tenth Circuit's failure to approve the Permian area rates, it did not decide the issue of

whether the applicable area rate should automatically be applied to initial certifications under Section 7. Because the issue has not been decided by a lower court, this Court should not decide it. Should this Court reverse the Commission in Permian, the issue would of necessity be remanded to the Commission.

ARGUMENT

INTRODUCTION

In *Phillips II (Wisconsin v. Federal Power Commission,* 373 U.S. 294 (1963)), this Court approved the Commission's attempt at determining just and reasonable producer rates by the use of an area as opposed to an individual method. But in approving the attempt, since it is the *result* reached and not the *method* used which is controlling, this Court made clear that it was not approving results; noting that the results of the area method would still be subject to review to determine if they meet the constitutional and statutory standards applicable to the Commission and its rate orders. It is the contention of Mobil, both as petitioner (Part I of this argument) and as respondent (Part II of this argument) that in regard to certain portions of its Permian decision, the results obtained by use of the area rate method do not meet applicable constitutional or statutory standards.

I. MOBIL AS PETITIONER

A. *The Commission Erred In Imposing A Dual Pricing Structure Which Classified Gas As "New" Or "Old" According To The Date Of Execution Of The Applicable Gas Sales Contract And Imposes Lower Rates For "Old" Gas.*

Under the Commission's concept of dual pricing, gas well gas and residue gas therefrom contracted to interstate

sale on or after January 1, 1961 is to receive a higher new gas price. Gas well gas committed to contract prior to that date as well as casinghead gas and all other residue gas is to receive a lower "flowing" gas price. (R. 563d-569d). Both prices are of course subject to quality deductions. The Commission has thus adopted a system of regulation where deliveries of similar quality gas during a given year may bring different prices. The Commission has adopted a system of rate regulation which ignores the economic characteristics of the industry and the necessity to generate internally the funds for future exploration. The Commission has raised the spector of entrapment whereby producers who commit gas in reliance on existing levels of price have no assurance that such rates will be maintained for the future. What is new gas at the present may well be lower priced flowing gas in future modifications of the Commission's opinion. Further, the Commission has indicated that the old rather than the new price of gas will be applicable to new reserves developed under previously committed acreage.

It is Petitioner's contention that the Commission's application of the dual rate structure in Permian results in regulation which is unjust and unreasonable in light of existing economic realities and the need for continuing replenishment of gas reserves.

1. *The Commission Is Bound In Its Regulatory Attempts By A Just And Reasonable Standard Which This Court Has Held Requires A Balancing Of Consumer And Investor Interest.*

In *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591 (1944), this Court, in an opinion by Mr. Justice Douglas, explained the just and reasonable regulatory standard of the Natural Gas Act.

> The rate-making process under the Act, i.e., the fixing of "just and reasonable" rates, involves a balancing of the investor and the consumer interests. 320 U.S. at 603.

Operating within this standard, the question remains: Is a dual pricing structure just and reasonable and a balance of both consumer and investor interests?

2. *The Two-Price System Ignores The Economic Characteristics Of The Producing Industry And Will Not Provide The Necessary Incentive For Future Exploration And Development Of Gas Reserves.*

By imposition of a dual price, the Commission has held that there are two maximum area rates which are just and reasonable to each affected producer and his various interstate sales. The basic Commission justification for a two-price structure is based on the conclusion that since the producing industry now possesses the ability to direct exploration toward either gas or oil, a higher rate should be allowed for "future" gas well gas in order to stimulate exploration activities for gas. Unlike earlier industry development when gas well gas was found merely as a by-product in the search for oil, and flared, the supply of gas is directly related to the price it receives in the maket place.

By its price justification for dual pricing, the Commission has contradicted itself. It has recognized that the cost of new gas is higher than flowing gas discovered when prices were lower. It has also priced flowing gas at what it considers to be the area level of the cost of finding flowing gas. Therefore, the Commission has acknowledged that the present replacement cost of gas is higher than the cost formerly encountered in finding flowing gas. Yet the industry is expected to replace gas

at present high costs with revenues based on the lower costs of flowing gas. The prime source of funds for exploration and development in the industry is current revenue. As Commissioner O'Conner recognized " . . . since the natural gas industry generates a large portion of its own capital, it thereby underwrites current exploration by the older production. Reinvestment is an accepted and necessary feature of the industry, and the revenues it receives must be a source of funds for continued and increased nationwide exploration and development." (R. 751d). The Commission's Brief to this Court ignores this factor when it states the price of flowing gas "will have no significant effect in eliciting additional supplies of gas." (Comm'n. Br., p. 87). The Commission itself has recognized that if consumer interests are to be supplied with gas to meet their demands, the producing industry must do more than merely replace the amount of gas consumed each year. (R. 568d). The Commission, in its opinion, took notice of the need for current generation of funds for future exploration and stated that it had not overlooked this factor and had included this need in the flowing gas price. (R. 566d). The question is *where* in the flowing gas price has this factor been considered.

In attempting to justify the dual pricing structure, the Commission relates the two-price structure to the home mortgage field. Noting that the ceilings for interest rates on FHA or VA loans are periodically established on the basis of what interest rates will then elicit sufficient mortgage funds, even though the rates will remain constant for the life of a twenty to thirty-year mortgage, the Commission stated that "Changes in these ceilings may mean that a mortgage obtained one day will be substantially more expensive than one obtained on the same type of

building a day earlier." (Comm'n. Br., pp. 88-89). Current ceilings for interest on government guaranteed home loans reflect the current money market. What the Commission overlooks in its analogy is that in determining current mortgage rate ceilings, the source and the time when money came into the mortgagee's hands are not considered. Regardless of the cost of the money to him, whether obtained when money is cheap or expensive, the current interest factor is allowed on a current mortgage.

Further, there is the possibility that the dual-price system will not provide the reward for exploration it is intended to encourage since the Commission could reduce the "new" gas rate after the producer has made a financial commitment on the basis of the new rate. The Commission's Brief to this Court acknowledges this possibility, but states that "such uncertainties inhere whenever government fixes prices" (Comm'n. Br., p. 89), and one can only "assume that should the Commission some day lower the price of new gas-well gas, it would do so prospectively." (Comm'n. Br., p. 89). This is little or no assurance to a producer risking millions of dollars in future exploration and committing gas interstate in reliance on a certain price level in order to recover the investment.

The Commission has also ignored the problem of new gas exploration under acreage previously committed to interstate sales by "old" contracts. The development of newer and more costly drilling equipment raises the possibility that newer and additional gas supplies may be developed by deeper drilling on committed acreage. Certainly the Commission will not deny that the cost of such gas is comparable to that encountered in drilling uncommitted acreage. This problem is not answered for Permian producers by the fact that the "point" is being considered

in another area proceeding. (Comm'n. Br., p. 92). Neither is the problem satisfied by citation to a "long-etablished policy of treating alike all gas from acreage committed under a contract. *E.g., Placid Oil Co.*, 26 F.P.C. 166." (Comm'n. Br., p. 92). This effect on new gas from "old" acreage clearly is an inconsistency in the Commission's dual pricing structure for the Permian area.

Finally, the Commission's dual pricing order ignores the economic fact that gas, as is any commodity, is sold for its present worth. In no other instance of group ratemaking are the present rates for services or commodities so restricted in relation to the date they entered the regulated market. By dual pricing the Commission attempts to impose a method of regulation which is not in conformity with the economic characteristics of the producing industry and is thus unjust and unreasonable.

B. *The Commission Erred In Proscribing The Filing Of All Rate Increases Above The Applicable Area Rate For A Specified Period And In Further Permanently Proscribing The Filing Of Rate Increases Under Certain Flexible Pricing Clauses In Existing Contracts.*

Two orders of the Commission, while presenting separate error, are interrelated and will be discussed within the framework of a single point for the purpose of clarity and understanding. Both provisions deal crippling blows to the right of a producer to seek a rate higher than the maximum rate levels authorized by the Commission. Both provisions represent an attempt by the Commission to proscribe the right of producers with previously certified sales to seek a higher rate allowed by and under a contract previously certified by the Commission. The first order to be discussed, the general moratorium, prevents the filing of any contractually allowable rate increases above the

applicable area rate for a specified time. The second order, applicable during and after the general moratorium, permanently bars the filing of rate increases allowable under certain proscribed pricing clauses in existing contracts. Both orders are an unreasonable and unjust attempt by the Commission to insulate itself from judicial review even though statutory provisions provide adequate protection for consumers.

1. *The Commission's Moratorium On Rate Increase Filings Is An Invalid Limitation On The Ratemaking And Rate Changing Principles Embodied In The Natural Gas Act.*

The Commission in its order determining area rates for the Permian Basin prohibited all contractually allowable Section 4 rate increase filings in excess of the applicable area ceiling until January 1, 1968, unless the Commission grants special leave to file in advance of that date. (R. 660d-669d). As the Commission correctly noted in its Brief to this Court (Comm'n. Br. p. 69; fn. 44), while this Court's decision may postdate the expiration of the original moratorium, the validity of the Commission's moratorium is important for other area rate proceedings as well as for possible extension or reinstatement of the Permian moratorium. Mobil questions the legality and reasonableness of the Permian moratorium in light of the expressed rate-changing rights granted by the Natural Gas Act and the expressed statutory duty of the Commission to regulate natural gas companies in a just and reasonable manner.

a. The Commission has no statutory power to impose a moratorium on contractually allowable rate increases in a proceeding determining just and reasonable rates.

Section 4(d) of the Natural Gas Act requires natural gas companies to file notice of proposed contractually

allowable changes in existing rates. The Commission may suspend the new rate for up to five months under Section 4(e), pending a determination of the justness and reasonableness of the proposed increase. If the Commission has not completed its determination at the end of the five-month period, the increase may be put into effect subject to refund if later found to be unjust and unreasonable.

Under Section 5(a) of the Act existing rates may also be changed. Under this section the Commission may order a rate change, not otherwise allowed by contract, upon a finding that existing rates are unjust and unreasonable.

While the procedures of both Sections 4 and 5 are addressed to the same general subject matter, that is to say, the changing of existing rates charged by a natural gas company, it is beyond question that each procedure is available only in certain prescribed situations. Thus, the Section 4(d) and 4(e) mechanism may be used only when a natural gas company seeks to change its rates by filing for contractually allowable increases. Section 4(d) not only expressly prohibits a gas company from changing its rates without complying with the procedure therein set out, but makes *no* provision for its invocation by *any other party*, namely the Commission. In contrast, Section 5(a) permits the initiation of the procedure there provided by the Commission or by "any State, municipality, State commission, or gas distributing company." Significantly, natural gas companies are omitted from the detailed enumeration of those authorized to invoke Section 5(a). Thus, Section 4(d) and (e) and Section 5(a) together deal with all situations in which changes in existing rates may be sought and each procedure complements the other. Rate changes in existing rates when initiated by a gas company are processed under Sections 4(d) and 4(e),

and when begun by someone other than the natural gas company itself are governed by Section 5(a).

The Commission places primary reliance for its moratorium power upon Section 5(a) which gives the Commission power to:

> [D]etermine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract *to be thereafter observed and in force,* and . . . fix the same by order . . . [Emphasis added].

By so doing the Commission confuses the proper roles for Sections 5(a) and 4(d) and (e) and attempts to apply Section 5(a), which does not set forth the rate changing procedures applicable to rate changes instituted by natural gas companies, to contractually allowable rate increase filings instituted under Section 4(d). As previously demonstrated Section 5(a) applies only to those proceedings instituted by the Commission, or "any State, municipality, State commission, or gas distributing company." A natural gas company may not institute a Section 5(a) proceeding. Further, the Commission may not institute a Section 4(d) and (e) rate increase filing. This is reserved exclusively for natural gas companies. Regulation under the Act, as evidenced by *Hope,* is a balancing of consumer and investor interests. 320 U.S. at 603. This is plainly evident in the filing and hearing rights granted by Sections 5(a), 4(d) and (e). To say that the language of Section 5(a) may be used to prevent Section 4(d) filing is to also say that the language of Section 4(d) may be used to prevent the Commission from instituting a Section 5(a) proceeding. Such was and is not the intent of Congress as evidenced by the plain and clear language of the Act.

The Commission also attempts to support statutory justification for the moratorium by reliance on a series of decisions by this Court interpreting both the scope of Sections 4(d) and 4(e) and defining the Commission's power over the initial certification of interstate gas sales under Section 7.

Quoting in support of the moratorium from *United Gas Pipe Line Company v. Mobile Gas Service Corporation*, 350 U.S. 332 (1956), the Commission notes that this Court has stated that:

> . . . §4(d) is simply a prohibition, not a grant of power. . . . it does not say under what circumstances a change *can* be made . . . 350 U.S. at 339.

Taken out of the context in which it was written, the statement seems to support the Commission's position. Aside from being an incorrect interpretation of what Mobil contends, is the true role of Section 4, as discussed previously, the Commission has failed to correctly interpret this Court's holding in *Mobile*. As has been expressed previously:

> [T]he fundamental teaching of *Mobile* [is] : . . that the Natural Gas Act, in preserving private contracts between the natural gas companies and their purchasers did *not* limit the companies' contractual rights to change rates. Hence if a gas company has the power (either by contract or otherwise) to change its rates, *that right is unaffected by the Act and continues in full force and effect*. . . . However, if the gas company has no such right apart from the Natural Gas Act, *the Act did not bestow that right upon it*, and it is without power to change its rates except with the agreement or acquiescence of its purchasers. [Comm'n. Br. to this Court in *United Gas Pipe Line*

Company v. Memphis Light, Gas and Water Division, Nos. 23, 25 and 26, October Term, 1958, p. 31]. (Emphasis added in part).

Thus *Mobile* stands for the proposition that:

> [T]he sole function of the notice-and-filing requirement of Section 4(d) is to enable the Commission to review, for compliance with the statutory standards, those new rates which a natural gas company may be empowered to file on the basis of authorization independent of the Act. [Comm'n. Br. to this Court, *United Gas Pipe Line Co. v. Memphis, supra,* p. 32].

And thus, Section 4(d) "does not say under what circumstances a change can be made" since this is left to the contracting parties. As this Court noted in *Mobile*:

> . . . §4(d) on its face indicates no more than that otherwise valid changes cannot be put into effect without giving the required notice to the Commission. . . . 350 U.S. at 340.

Further in *Mobile,* this Court, in a unanimous decision delivered by Mr. Justice Harlin recognized that the Natural Gas Act was not intended "to abrogate private rate contracts as such" and as the Commission has observed in its Brief to this Court in these proceedings: "This Court held in . . . *Mobile* . . . that under the Natural Gas Act rate regulation is superimposed on—not substituted for—private bargaining." (Comm'n. Br., p. 93).

Subsequently, in *United Gas Pipe Line Company v. Memphis Light, Gas & Water Division,* 358 U.S. 103 (1958), this Court recognized that the corollary of *Mobile* was that where the contract left the seller free to file rate increases in an existing rate, he could act

unilaterally under Section 4 and file such rate increases with the Commission. The rationale of the two decisions was best expressed by this Court in *Sunray Mid-Continent Oil Company v. Federal Power Commission,* 364 U.S. 137 (1960).

> In Mobile, this Court held that where a seller of gas had entered into a contract for the sale, it could not, by virtue of the provision in § 4 for rate changes, file an increase in rates that violated the terms of the contract. This was because the scheme of the Act *was one which built the regulatory system on a foundation of private contracts.* It was held in the Memphis case [citation omitted] that the corollary of Mobile was that where the contract left the seller free to act, he could act unilaterally under § 4. 364 U.S. at 154-155. (Emphasis added).

Of course, implicit in the reasoning of the Court in both *Mobile* and *Memphis* is the assumption that although Section 4 allows the filing of contractually permissible rate increases and the collection of the increased rate subject to refund, the increased rate does not become final and binding until the Commission has determined it to be just and reasonable. This is the protection which the Act provides for the consumer while the justness and reasonableness of the increase is being tested. Contrary to the impression which the Commission attempts to foster, the mere filing of a contractually allowable rate increase does not mean that it automatically becomes the just and reasonable rate. Only after a hearing on the increase does the Commission make this determination. In both *Mobile* and *Memphis* there is no indication or intimation in either decision that the Commission may abandon its duty and obligation under Section 4 to determine if contractually allowable rate increases are just

and reasonable at the time of their filing by proscribing their filing. The Commission is not empowered under the Act to thus insulate itself from judicial review by producers desiring to question the level of applicable area rates.

This Court in *Sunray Mid-Continent* reiterated perhaps the most important reason for Congress allowing, in the Natural Gas Act, unrestricted filing of contractually allowable rate increases. Recalling its decision in *CATCO (Atlantic Refining Company v. Public Service Commission of the State of New York*, 360 U.S. 378 (1959)), this Court observed:

> An initial application of an independent producer to make movements of natural gas in interstate commerce, leads to a certificate of public convenience and necessity under which the Commission controls the basis on which "gas may be initially dedicated to interstate use. Moreover, once so dedicated there can be no withdrawal of that supply from continued interstate movement without Commission approval. The gas operator, although to this extent a captive subject to the jurisdiction of the Commission, is not without remedy to protect himself." 360 US, at 389. That remedy he has, as the Court there said, in the "change" power under § 4(d) when his contract has expired or *where his contract permits its use during its term.* 364 U.S. at 156. (Emphasis added).

Thus, clearly this Court has recognized and stated the importance of the rate changing provisions of Section 4 to a producer. As the *Sunray* decision observed, this Court in *CATCO* noted that a producer who commits gas to interstate sale is not without protection.

> He may, *unless otherwise bound by contract,* United Gas Pipe Line Co. v. Mobile Gas Service Corp. [cita-

> tions omitted] file new rate schedules with the Commission. 360 U.S. at 389. (Emphasis added).

This Court's decision in *CATCO* is important in the history of producer regulation. In *CATCO* this Court directed the Commission to use the authority granted under Section 7 and its conditioning power to control the initial entry of gas to the interstate market and to "hold the line" on producer rates pending determination of "just and reasonable" rates. Based on the rationale of *CATCO*, this Court has subsequently approved procedures adopted by the Commission under Section 7 to accomplish this purpose. However, the Commission now attempts to extend the *CATCO* rationale to a proceeding actually determining just and reasonable rates and attempts to confuse the power granted under Section 7 with the expressed rights of producers under Section 4.

In *Federal Power Commission v. Hunt*, 376 U.S. 515 (1964), this Court was confronted with an issue as to the exercise of the *CATCO* inspired use of the conditioning power of Section 7, and its effect on the filing rights of Section 4. As this Court stated:

> These sections [§§ 4 and 7] are the avenues through which the natural gas producer may, by contract or otherwise, initially propose the dedication of his natural gas supply to interstate movement (§ 7) and, once so dedicated by order of the Federal Power Commission, thereafter initiate changes in existing rates. 376 U.S. at 519.

After a careful analysis of both sections, this Court observed that:

> The power granted to the Commission in § 4 does not come into play until after the initial certification of

> the natural gas into interstate commerce has been granted under § 7. 376 U.S. at 521.

Thus, a line is clearly discernible between those procedures allowed under the guise of Section 7 and the proceedings allowable under Section 4. At issue in *Hunt* was whether the Commission, operating under the conditioning power of Section 7 could grant a temporary certificate conditioned upon the producer agreeing not to file for rate increases under Section 4 of the Act during the pendency of the temporary certificate. The Commission imposed a moratorium for the term of the temporary certificate. This Court agreed that such a procedure and the moratorium was allowable under the authority granted the Commission by Section 7 in initially certifying producer sales.

> Clearly, the Commission was given the power to lay down conditions precedent to the entry of the natural gas into interstate commerce. 376 U.S. at 526.

The power of the Commisssion over the initial entry of gas into interstate commerce under Section 7 was further defined by this Court in *Federal Power Commission v. Texaco,* 377 U.S. 33 (1964) where approval was given to Commission regulations proscribing certain flexible pricing clauses in future contracts committing gas to interstate sale for resale.

Finally, in *United Gas Improvement Company v. Callery Properties,* 382 U.S. 223 (1965) this Court spoke again regarding the power of the Commission over the initial entry of gas into the interstate market. In approving the authority of the Commission to impose a moratorium on increase rate filings under Section 4

through use of the certificating power in a permanent certificate, notation was made, and strongly emphasized, that this was an interim measure to be allowed *pending* determination of just and reasonable rates. This Court noted that the conditioning of the permanent certificates "was . . . aimed at keeping the general price level relatively constant pending determination of the just and reasonable rate." 382 U.S. at 228. And, in affirming the action of the Commission the Court stated further:

> We think, contrary to the Court of Appeals, that there was ample power under § 7(e) for the Commission to attach these conditions for consumer protection during this interim period . . . . 382 U.S. at 228.

In so holding, this Court reiterated the *CATCO* rationale:

> We said in CATCO that § 7 procedures are designed "to hold the line awaiting adjudication of a just and reasonable rate." 382 U.S. at 228.

Thus, the restrictions which this Court has previously allowed the Commission to impose upon the filing rights granted by Section 4 have been necessitated by the Court's and Commission's desire to maintain stability pending determination of just and reasonable rates.

The Commission's decision in these proceedings is a determination of just and reasonable rates. The period of pendency spoken of in *Callery* has ended. Yet in its imposition of the moratorium, the Commission draws upon the authority given it under Section 7 during the period between initial certification and before just and reasonable rates are determined. Clearly this is not supportable from the decisions previously decided by this Court.

The Commission also attempts a comparison between the Interstate Commerce Act and the Natural Gas Act to justify the moratorium. However, in so doing the Commission overlooks two important and distinguishing points. First, as this Court observed in *United Gas Pipe Line Company v. Mobile Gas Service Corporation, supra,* in discussing the differences between the Interstate Commerce Act and the Natural Gas Act:

> In construing the Act [Natural Gas Act], we should bear in mind that it evinces no purpose to abrogate private rate contracts as such. To the contrary, by requiring contracts to be filed with the Commission, the Act expressly recognizes that rates to particular customers may be set by individual contracts. In this respect, the Act is in marked contrast to the Interstate Commerce Act, which in effect precludes private rate agreements by its requirement that the rates to all shippers be uniform, a requirement which made unnecessary any provision for filing contracts. See Armour Packing Co. v. United States, 209 US 56, 52 L ed. 681, 28 S Ct 428. *The Commission in its brief recognizes this basic difference between the two Acts and notes the differing natures of the industries which gave rise to it.* 350 U.S. at 338. (Emphasis added).

Thus, the Commission's reliance on *Nashville Traffic Bureau v. Louisville & Nashville Railroad Co.,* 53 I.C.C. 37, 38 as justification for the moratorium is improper. Under ICC regulation a common carrier may not raise its rate above that set by the ICC by merely publishing new rates. It must return to the ICC for relief, since all rates for a particular service are uniform and not based on individual contracts. Therefore, the effective order of the ICC must be "thereafter observed" until changed, otherwise the shipping public is unprotected if a company may

unilaterally change its rates. Again, the provisions of Section 4(e) of the Natural Gas Act prevent a filed rate increase from becoming the just and reasonable rate unless the Commission so orders.

Neither is the Commission's reliance on The Packers and Stockyards Act proper. The decision in *United States v. Corrick,* 298 U.S. 435 (1936), relied upon by the Commission, is a companion case to *Acker v. United States,* 298 U.S. 426 (1936), both decisions being decided May 18, 1936 with both opinions by Mr. Justice Roberts. This Court has also considered the Stockyards Act in *Tagg Brothers and Moorehead v. United States,* 280 U.S. 420 (1930). The Stockyards Act imposed regulation by the Secretary of Agriculture over services performed by commission merchants at stockyards where "Little capital is invested; the business is the rendering of personal services for which charges are made according to a uniform schedule." 298 U.S. at 428. As in the case of the ICC, the rates under the Stockyards Act are in force and effect until changed by the Secretary. Since the service performed by each merchant was identical with uniform cost and risk, the merchants themselves, prior to federal regulation, had agreed among themselves to charge uniform rates. Regulation was imposed to insure that these uniform rates were just and reasonable in relation to cost and risk. Therefore, the uniform maximum imposed by the Secretary must continue until changed by him, otherwise commission merchants could resort to their own uniform maximum.

Even forgetting the dissimilarities between the various statutes and the Natural Gas Act, the Commission gains little by placing reliance on the "to be thereafter observed" language of other statutes. Under the Natural Gas

Act, the mere filing of a rate increase under Section 4 does not necessarily mean that the increased filings become the just and reasonable rate "to be thereafter observed." Of course, if the Commission suspends the increase and has not completed its hearing on the justness and reasonableness of the increase prior to the expiration of a five-month period, the producer may require that the increase be placed in effect, but the Commission may also require, as is usual practice, that the increase be placed in effect subject to refund with interest if later found to be unjust and unreasonable. Thus, if the Commission determines just and reasonable rates "to be thereafter observed" in a Section 5(a) proceeding, these rates are in force until changed by the Commission. By a contractually allowable filing under Section 4(e), a producer does not unilaterally change an existing rate the Commission has found should "be thereafter observed." That change may only come after the Commission finds the increase just and reasonable. If the increase is not just and reasonable then a refund is made and the old rate is still "thereafter observed."

The Commission's contention (Comm'n. Br., p. 73), that "if any additional authority for such action [the moratorium], beyond that provided in Section 5(a) itself, is required, it is provided by the broad language of Section 16", ignores completely the proper role for that rulemaking section. The rulemaking authority of the Commission may be used to implement that authority granted by other sections of the Act. However, it is *not* an independent grant of authority which may be used to override expressed rights granted by other sections. Section 16 itself makes very clear that it shall be used "to carry out the provisions of this Act."

b. The moratorium which the Commission has imposed is not essential to an area method of regulation and its imposition conflicts with principles which any method of group regulation must meet.

Assuming that it has statutory authority for imposition of the moratorium, the Commission asserts that the moratorium imposed "was appropriate in the circumstances." (Comm'n. Br., p. 73). In making this assertion, the Commission ignores several facts of regulatory life under its own Permian Decision. First, in the Permian exemption provisions, the Commission specifically bases eligibility on "a producer who has *contracted* for an above-ceiling price." (R. 657d). It is an accepted fact of regulation under the Natural Gas Act that during the term of a contract, the contract price fixed by the parties determines the maximum price which the producer may receive. As the Commission has observed "under the Natural Gas Act rate regulation is superimposed on—not substituted for—private bargaining." (Comm'n. Br., p. 93). In order for a producer to be able to take advantage of *any* exemption provisions, and Mobil objects to the sufficiency of the Commission's present exemption provision for Permian, there must be an existing contractual right to seek a rate higher than the maximum area rate. If the Commission is allowed to proscribe all rate increase filings, those contracts which must depend on rate increase filings to place them above the area rate offer a producer no opportunity to take advantage of any exemption. There is no need to discuss the principle, applicable to any method of group rate regulation, that an effective and workable exemption is required. See *King v. United States*, 344 U.S. 254 (1952).

Second, the Commission attempts to impress the Court with the assertion that the "area proceeding would be

quickly set at naught" if the moratorium is not upheld. (Comm'n. Br., p. 69). This again ignores the fact that rate increase filings do not automatically become the effective area rate. Only after the Commission finds the increase to be just and reasonable does it "set at naught" an existing rate. Further, the Commission's contention that the moratorium is "appropriate in the circumstances" is defective for the reason that the Commission has assumed that no rate increase to be filed during the moratorium period will be just and reasonable. This is an assumption which the Commission may not make from the record before it in this proceeding. The moratorium is in effect from September 1, 1965, the effective date for the Permian decision until January 1, 1968. This record contains, as well it may not since it was closed prior to the Commission's decision, no actual cost figures for the moratorium period. The Commission attempts to gloss over this deficiency by stating that "The new gas well gas [gas contracted to interstate sale subsequent to January 1, 1961] price primarily reflects national data for years through 1963, *projected to subsequent years.*" (Comm'n. Br., p. 74). Thus, by a *projection* of pre 1964 data the Commission is attempting to prevent producers from making an *actual* showing of cost and possible other evidence which would show rate increase filings made during the moratorium period to be just and reasonable. Mobil contends this is not in keeping with the proper application of the just and reasonable standard.

2. *The Commission Erred In Proscribing Pricing Clauses In Contracts Previously Approved And Made The Basis Of Certificates Of Public Convenience And Necessity.*

Supplementing the general moratorium, which prevents the filing of all contractually allowable rate increases above

the maximum area rates until January 1, 1968, the Commission has permanently forbade contractually allowable rate increase filings above the maximum area rates based on any price-changing provisions that would not be authorized under Section 154.93 of its Regulations. (R. 682d-683d). This prohibition is applicable both during and after the general moratorium. Section 154.93 prevents producer sales contracts executed on or after April 3, 1961 which contain most favored nation, spiral-escalation and other indefinite pricing provisions from being filed with the Commission after April 2, 1962 for initial certification under Section 7. Until the Permian Decision, the prohibition of Section 154.93 was not applicable to those contracts which had been accepted for filing in Section 7 certifications prior to its effective date.

This Court has sustained the Section 154.93 prohibitions as they now exist in Commission regulation. *Federal Power Commission v. Texaco,* 377 U.S. 33 (1964). However, this Court's decision did not deal with the retroactive application of the 154.93 prohibitions, as the Commission now proposes in Permian. Unlike the *Texaco* proscription which was only applicable to future contracts when promulgated, the Permian proscription applies to existing contracts that were negotiated and filed by the parties when Commission approval was being given to contracts containing such clauses. Relying on the pricing provisions contained in their contracts to cover present and future costs, producers, with the approval of the Commission, committed gas to interstate sale. Under Section 7(b) of the Act, such sales must be continued until the Commission approves abandonment. It is Mobil's contention that the Commission's permanent proscription is unreasonable and invalid in light of this Court's decision in *Texaco;* the

rate changing provisions of the Act; the Commission's prior approval and acceptance of the proscribed contract clauses; and, producers commitment of gas to interstate sale in reliance on Commission approval of the sales contract.

The Commission, in its brief to this Court, attempts to justify the permanent proscription of the clauses by reliance on Section 5 of the Act stating that "The Commission has express authority under Section 5 of the Act to modify contractual provisions after a hearing." (Comm'n. Br., p. 77). However, the Commission fails to specifically note that its actions in modifying contracts under Section 5(a) are to be judged by the just and reasonable standard, which this Court has already held in *Hope* involves a balancing of both consumer and investor interests. Further, the Commission relies on its asserted authority to impose a general moratorium as additional justification for the permanent proscription. (Comm'n. Br., p. 77). As Mobil has previously contended, the imposition of the general moratorium by the Commission is likewise invalid in light of statutory provisions as well as any test of reasonableness. But even if this Court were to uphold the Commission in the imposition of the general moratorium for a limited period, the actions of the Commission in permanently proscribing flexible pricing clauses in existing contracts are invalid for the reasons stated herein. An affirmance by this Court of the moratorium does not require that the ban on flexible pricing clauses also be affirmed. After expiration of the moratorium all rate increase filings except those based on flexible clauses are to be allowed by the Commission's present orders.

Since the promulgation of the orders of the Commission which are now set forth in Section 154.93, producers

in negotiating sales contracts have been on notice that indefinite pricing clauses should not be included otherwise the Commission will not allow the contract to be filed. Therefore, other and acceptable pricing clauses are now included to cover rising costs in the future. But producers whose sales contracts were executed prior to April 3, 1961, the present effective date of Section 154.93, are trapped in a position from which they may not extricate themselves. Contracts were negotiated and executed on the basis of the acceptability of indefinite as well as other pricing clauses. Numerous contracts of the period contain only indefinite pricing clauses for future price increases. Many contracts contain indefinite as well as other clauses. These producers now find contracts which they have relied upon, which the Commission has previously approved, which sales have been made under, and under which substantial amounts of gas have been committed to interstate sales suddenly severely limited in regard to the contractually allowable price. In effect the Commission has rewritten contracts previously approved by it. Such actions hardly seem in accordance with any test of reasonableness.

The Commission attempts to justify the proscription by noting that it is one which only limits, but does not destroy flexible clauses in existing contracts, since a producer may use a flexible clause to file up to the maximum area rate. (Comm'n. Br., p. 79). This ignores the real issue. The Commission has completely and permanently destroyed the ability of producers to file for rates above the maximum area rate, if based on a flexible pricing clause.

The Commission charges that flexible pricing clauses "are clearly contrary to the public interest," and contends that this Court has already sustained that view in *Texaco*. (Comm'n. Br., pp. 77-78). In *Texaco*, this Court held

that Commission orders in proscribing flexible pricing clauses in contracts to be filed for *future* certification were supportable by reason of the control over initial certification given the Commission by Section 7(e).

> And, where, as here, applications for certificates are made under §7 of the Act, the Commission under §7(e) is required to control the terms and conditions under which natural gas companies . . . may initiate sales at wholesale of natural gas in commerce. 377 U.S. at 41-42.

The proscription which the Commission prescribed in Permian is not over a gas sale which is to be initiated, it is over a sale that has already been initiated, approved by the Commission, and which is continuing under an existing contract.

In *Texaco* this Court also commented on the regulatory authority of the Commission as to existing contracts.

> In a rate case under §5(a) of the Act the Commission can pass on existing contracts affecting rates, can find that particular contracts are "unjust, unreasonable, unduly discriminatory, or preferential" and thereupon has power to determine the "just and reasonable" rate or contract and "fix the same." 377 U.S. at 41.

Thus, in changing existing contracts the Commission is *bound* by the just and reasonable standard, which this Court stated in *Hope* is a standard which requires a balancing of consumer and investor interests. 320 U.S. at 603. It hardly seems a balance to deny producers the right to file for rate increases under previously approved pricing clauses, even after the Commission itself is to allow all other rate increase filings. What is acceptable for reg-

ulating future contracts and the initial entry into commerce is not necessarily acceptable in regulating existing contracts and sales in commerce.

The proscribing of pricing clauses in existing contracts is vastly different from controlling pricing clauses in initially certifying a sale, and this Court has previously observed the difference in pointed language. In *Phillips II* (*Wisconsin v. Federal Power Commission*, 373 U.S. 294 (1963)), where this Court approved the Commission's attempt at determining just and reasonable producer rates by use of the area method, the Commission had refused to declare "void *ab initio*" certain spiral escalation clauses in existing contracts on which three Section 4(e) rate increases were based. 373 U.S. at 303. This Court had "grave doubts" as to whether the issue could be raised at that time, but did offer this comment:

> Further, we see no merit in California's [the complaining party] contention. It is true that the Commission has announced *prospectively* that it would not accept for filing contracts containing such clauses [the Court here footnoted the various Orders which form Section 154.93], but it would have been quite a different matter for the Commission to have declared that *past* rate increases were ineffective simply because they were based on sipral provisions. The effect of a contract clause of this type, of course, is only to permit the producers to resort to the filing provisions of §4(d) of the Act. If the increase is challenged, the producer must still establish its lawfulness wholly apart from the terms of the contract. Thus we have sustained the right of a seller to file an increase under a contract which, in effect, authorized him to do so at anytime. United Gas Pipe Line Co. v. Memphis Light, Gas and Water Div. 358 US 103, . . . The spiral clauses here are far more limited

> in scope, depending as they do on the occurrence of external events. 373 U.S. at 304.

Likewise, it is "quite a different matter" for the Commission to declare invalid rate increase filings under existing and previously approved contracts simply because they are based on flexible pricing clauses. This permanent ban is even less acceptable when consideration is given to the fact, as illustrated by this Court in the above quoted section from *Phillips II*, that both the investor and consumer interests are adequately protected when a rate increase filing based on a flexible clause is made under Section 4(e).

The Commission attempts to build an argument for the "indefinite" proscription by stating that such clauses "are also inconsistent" with the dual pricing system. This of course assumes the validity of dual pricing, which is also at issue before this Court, and which Mobil among other parties contends is unjust and unreasonable in and of itself. (See Part IA of this Brief.) But assuming for the sake of argument that the Commission is sustained in regard to dual pricing, it is still no justification for proscribing filings based on the flexible clauses, which is attempted by the statement: "But limiting these clauses is highly important, since they would permit the escalation of flowing-gas prices to the new gas well gas price level and thereby disrupt the operation of the two-price system." (Comm'n. Br., p. 78-79). This again ignores the fact that after the expiration of the general moratorium, all rate filings, except flexible filings, are to be accepted by the Commission. The filing of these acceptable rate increases will "disrupt" the two-price system as much if not more than "flexible" filings. Certainly, the Commission does not wish to say that because of the dual pricing system it may permanently ban

all rate increase filings, whether based on flexible clauses or otherwise.

C. *In Determining Just And Reasonable Rates Under Sections 4 And 5 By Compiling Composites Of Group Costs The Commission Erred In Excluding From Such Composites The Costs Incurred By The Producing Industry In Gathering And Processing Natural Gas For Sale To Pipeline Purchasers.*

In determining the maximum area rate, the Commission allowed the same rate for gas sold at the tailgate of a processing plant and for gas sold at the wellhead prior to gathering and processing. The Commission refused to consider or include in its composites of cost for both new and flowing gas an item representing the average industry cost of processing and gathering. It is Mobil's contention that such deletion is unreasonable and unjust, and that such costs are necessary in a pricing system based upon average of industry costs in producing gas and delivering it to the facilities of a purchasing pipeline.

Gathering and processing are essential and necessary functions of the natural gas industry in bringing gas from the reservoir to the consumer's burner tip. In the industry, gathering and processing are sometimes handled by the producers themselves, by the purchasing pipeline, or by a third party. When handled by producer, the cost incurred is as legitimate and necessary a cost as when handled by an interstate pipeline making wellhead purchases.

The producing and gathering exemption found in Section 1(b) of the Act does not prevent the Commission from including gathering costs in its composition of the items comprising an area cost for gas. This is amply borne

out by the position taken by this Court when reviewing earlier efforts of the Commission in regulating interstate pipelines with gathering and processing facilities and costs.

In *Colorado Interstate Gas Company v. Federal Power Commission,* 324 U.S. 581 (1945), this Court decided directly what had been indicated indirectly in *Hope* as to the inclusion of producing and gathering facilities of a pipeline in its rate base. Both this Court and the Commission agreed that there should be such an inclusion since the production and gathering exemption of Section 1(b) was not prohibitive on the subject. As this Court stated, after noting that the exemption of Section 1(b) was applicable to prevent Commission jurisdiction over drilling, well spacing and possible other like limitations:

> We only decide that it [the exemption] does not preclude the Commission from reflecting the production and gathering facilities of a natural-gas company in the rate base and determining the expenses incident thereto for the purposes of determining the reasonableness of rates subject to its jurisdiction. 324 U.S. at 603.

Further in both *Colorado-Wyoming Gas Company v. Federal Power Commission,* 324 U.S. 626 (1945) and *Panhandle Eastern Pipe Line Company v. Federal Power Commission,* 324 U.S. 635 (1945), this Court upheld the Commission in including a pipeline's gathering facilities in its rate base. True enough, *Colorado Interstate, Colorado-Wyoming,* and *Panhandle* involve an individual pipeline rate proceeding. However, the decisions of this Court clearly indicate that the Commission, as far as the producing and gathering exemption of Section 1(b) is concerned, does have the authority to include the costs of gathering as well as production in determining the rate of

a "natural gas company." Relevant also is the fact that *Phillips I*, which held independent producers to be "natural gas companies" and thus subject to Commission regulation, relied heavily on the reasoning of *Colorado Interstate* in rejecting the argument that the exemption of Section 1(b) prevented Commission regulation of a producer's interstate sales. See *Phillips Petroleum Company v. Wisconsin*, 347 U.S. 672, 678 (1954). And further, in *Phillips I*, this Court dealt specifically with a situation where the independent producer gathered the gas and sold it to an interstate line *after* gathering was completed. See 347 U.S. at 674-675.

It is also clear from the pipeline rate cases discussed above, as well as from subsequent cases, that when and if gathering is performed by a pipeline, the facilities incident thereto are included in the rate base and pipeline rates adjusted accordingly, thus passing such costs along to the consumer. By failing to adopt similar treatment for producers, the Commission in determining maximum area rates has only computed the cost of finding and producing gas, has omitted from its cost computations a portion of the legitimate expenses of producers and has left a "cost gap" in producer rate regulation, not so "attractive" to producers, between wellhead production and sales after gathering is complete.

It is true that the non-jurisdictional activity of extracting and selling natural gas liquids must be considered by the Commission under its adopted procedure in determining a national and/or Permian area average for processing and gathering to be included in the cost of gas. There are common producing, gathering and processing costs which must be allocated between the extracted liquids and the gas sold to an interstate pipeline, and the Com-

mission has so allocated in individual producer proceedings. See *Phillips Petroleum Company*, 24 F.P.C. 537, 562-565 (1960). Further this allocation is not an impossible task in an area proceeding as the Commission has itself demonstrated in determining a "net liquid credit" (*i.e.*, net only of production taxes and royalties (R. 589d)) average which was subtracted from all other averages in determining the cost of new gas. (R. 586d-590d). The credit was based on revenues received from both wellhead condensation and plant extraction (R. 589d). The presence of the "net liquid credit" is but another indication of the unjustness and unreasonableness of the Commission's actions in failing to include processing and gathering costs: the Commission has subtracted a "credit" without including those costs from which the credit should properly be subtracted. A figure based on both wellhead and plant revenues has been subtracted from a figure which represents only wellhead costs. Such a procedure hardly is a "balancing of consumer and investor interests" as required by *Hope*.

Because the initial determination of an average cost for processing and gathering is a function which the Commission must determine from the record before it, neither Mobil nor this Court can or should attempt to arrive at a specific figure. However, the Commission should be directed to make the determination, either from the record now before it or with the addition of any additional evidence it may desire.

II. Mobil As Respondent

In *Phillips II* this Court observed that:

> The Commission has stated in its opinion in this proceeding that the goal is to have rates base on the

> "reasonable financial requirements of the industry" in each production area . . . 373 U.S. at 310.

In these proceedings it is evident that the Commission has determined that the industry revenue requirements for new gas are the applicable area maximum of 16.5 cents and that the industry revenue requirements for old or flowing gas are the applicable area maximum of 14.5 cents. Together with the revenue generated by application of the area minimum of 9 cents, these area maximums are supposed to produce the overall revenue requirements for the industry in the Permian Basin. However, having determinded the revenue requirements, the Commission has not provided a rate design which will allow recovery of these rates. The return which the Commission allows on production investment is improper; but even considering its propriety, the yield actually returnable, while not precisely known, is less than what the Commission has determined to be just and reasonable. Thus the end result becomes unjust and unreasonable. This deficiency is further accented by the Commission's minimum rate order, which fails to aid the producer in recovering the revenue requirement. And, as a final element, the Commission, although it can not determine if the revenue requirements which is has determined are to be reached because of the improper treatment for rate of return, has ordered a refunding of all amounts collected above the applicable area rates by individual producers. These, and other errors by the Commission discussed in this second part, along with those points previously discussed, render the results of the area method expressed in the Permian decision clearly unjust and unreasonable.

A. *The Commission Failed To Adopt A Fair Rate Of Return And Then Denied The Industry The Opportunity To Earn That Adopted Rate.*

The Commission in determining a fair return in its first area rate proceeding adopted "a return of 12 percent on production activities" as being the fair rate of return which would protect gas consumers against excessive prices for new and flowing gas but which would not be so low that it would fail to respond to the needs of the industry. (R. 606d). The rate of return on production items purports to include, in addition to an allowance for exceptional risks and the impact of quality deductions in both the rate of return for new and flowing gas (R. 614d), an allowance in the flowing gas rate of return to compensate for producers' need to finance future exploration from current revenue. (R. 633d). Thus, as developed by the Commission, the rate of return purports to be a combination of three factors: a return on production investment an allowance for the impact of quality deductions; and a means to generate current funds for future exploration.

The test for what is or is not a proper rate of return has been explicitly stated by this Court on at least two separate occasions. First, in *Bluefield Water Works and Improvement Company v. Public Service Commission,* 262 U.S. 679 (1923) this Court stated that what "rate will constitute just compensation depends upon many circumstances and must be determined by the exercise of a fair and enlightened judgment, having regard to all relevant facts." 262 U.S. at 692-693. But considering all circumstances and relevant facts, this Court then noted that:

> A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal

> to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties . . . A rate of return may be reasonable at one time and become too high or too low by changes affecting opportunites for investment, the money market, and business conditions generally. *Idem.*

Second, in *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591 (1944) this Court, in an opinion by Mr. Justice Douglas stated that the revenue obtained from a rate should allow not only operating expenses but also capital costs and noted that:

> By that standard the return to the equity owner should be commensurate with return on investments in other enterprises having correponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital. 320 U.S. at 603.

The Commission recognized the principles of *Bluefield* and *Hope* which this Court has announced as governing rate of return. (R. 598d). However, having recognized them as controlling and binding, neither the resulting dollar return nor the rate of return fixed by the Commission is acceptable when judged against those standards.

In adopting 12 percent as the fair rate of return, the Commission relied on several considerations "particularly the testimony of witnesses Shaffner and Morton with respect to the returns by nonintegrated producers in the Permian Basin." (R. 606d).[2] The Commission also

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2. The Commission noted (R. 604d) that the average rate of return for witness Shaffner's sample of seven non-integrated producers with Permian Basin operations was 13.4 percent for the 1957-1961

specifically recognizes that investment in the exploration and producing industry represents a higher degree of risk than investment in the pipeline industry. (R. 599d). Contrary to the doctrine of *Hope,* the Commission's 12 percent rate of return allowance does not meet the basic test of providing this industry the opportunity to earn a return equal to that of other industries with corresponding risks and uncertainties. It is not adequate to generate the flow of funds for gas exploration and development projects. Furthermore, by the Commission's own computations, the industry has not been allowed to earn the fair rate of return which it adopted.

The basic flaws in the Commission's rate of return analysis are (1) its failure to consider the substantial comparable earnings evidence in the record demonstrating what other industrial groups, especially Commission regulated pipelines, have earned on equity capital over a relevant period of time and (2) to provide for the special risks of the gas producing industry. Moreover, the Commission failed to consider the substantial evidence regarding the significant increase in earnings ratios reported for the major industrial groups, the rising cost of debt capital and the significant decline in the purchasing power of the dollar. The 1957-1961 period considered representative by the Commission in determining the fair rate of return covers the period of depressed earnings following the first Suez crisis, and encompasses two of the four well-documented recessions since World War II—namely in

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period. Dr. Morton's sample of 13 non-integrated producers earned an average rate of return on average capitalization of 14.5 percent for the same period. On common stock equity the return was 15.4 percent. During the longer more representative period, 1947-1961, Dr. Morton's sample earned average rates of 18.1 percent and 19.5 percent on total average capitalization and average equity, respectively. (Ex. 220, Sch. A-29). (R. 685e).

1958 and in 1960-1961. Furthermore, Dr. Shaffner's Exhibit No. 176, Schedule No. 19 (R. 562e), shows that the producing industry did not share in the general recovery of the economy that took place between 1959 and early 1960. In fact, the same exhibit (R. 561e) shows that since World War II, no five-year period could have been selected that resulted in a lower average rate of return that the 1957-1961 period relied upon by the Commission. Since 1961, rates of return in the economy generally and for the producing industry, in particular, have improved significantly. At the same time, interest rates on new debt capital have climbed to their highest levels since before World War II. Therefore, the 1957-1961 period is not representative of prior or current conditions in the capital markets and the data relied upon by the Commission seriously understate the fair rate of return required by the natural gas producing industry. Sufficient incentive to search for and develop adequate future natural gas supplies at reasonable prices is the key to the protection and growth of consumer requirements as well as of the nation's huge investment in transmission and distribution facilities.

Assuming, *arguendo*, that 12 percent represents a fair rate of return for the gas producing industry, nevertheless, the actual return, by the Commission's own admission, falls short of this yield. The Commission's Brief candidly states that:

> . . . this meant that the prescribed area rates might yield as little as *about* 10¾ percent overall (*about* 12 percent on *equity*) on average quality new gas-well gas, and *possibly only slightly* more than 9 per cent overall (about 10 percent on (*equity*) on the average quality of old gas-well gas." (Comm'n. Br., p. 141). (Emphasis added).

Thus, the lack of opportunity to earn a fair rate of return is self evident. Moreover, the return on equity is shown by the Commission to be equal to or below that of returns on equity of Commission regulated pipelines in spite of the fact that it points out significant risk differentials between pipelines and producers. (R. 598d-601d). Since 1947, the average rate of return on equity for regulated natural gas pipelines has been 12.0 percent (Source: FPC, *Statistics for Interstate Natural Gas Pipeline Companies*). The annual averages ranged from 10.8 percent in 1963 to 13.6 percent in 1956. Since 1961 the average has been 11.9 percent. Obviously the rates on equity estimated by the Commission in its brief of "about 12 percent on equity" for new gas well gas and "about 10 percent on equity" for old gas well gas are inadequate and unfair when compared with the higher rates yielded by admittedly safer pipeline investments.[3]

The errors of the Commission, as previously indicated, are that the 12 percent rate of return adopted is inadequate and that the Commission has burdened the adopted rate of return with other factors so that the actual return to be earned is not only highly uncertain but also impossible to achieve on a group basis. It is not only impossible for the natural gas producing industry to average 12 percent rate of return because of quality deductions, but also impossible for the industry to achieve the 9 percent and

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3. Average rates of return on average common equity of privately-owned electric utilities ranged from 11.0 percent in 1958 to 12.6 percent in 1965. The average rate for the 1955-1965 period was 11.5 percent. (Source: FPC, *Statistics of Electric Utilities in the United States, 1965, Privately Owned*). Hence, the very low risk electric utilities, regulated by the Commission, have earned higher rates of return on equity in past investments than the 10 percent now contemplated for producer investments in "old gas-well gas" and both "old and new" casinghead gas.

10-3/4 percent levels now suggested for the first time in the Commission brief. Some of the factors that preclude these average yields are (1) price limitations below area ceilings in a substantial number of contracts; (2) quality deductions below the so-called standards for "pipeline quality gas"; (3) applying the rate of return to a base which excludes a significant and necessary portion of the industry's investment outlays; (4) inclusion of an unrealistically short time lag in the rate base; (5) applying the rate of return to a theoretical rate base (for new gas well gas) consisting of only one-half the investment outstanding over an *assumed* 20-year period; and (6) underestimation of several important cost components such as successful well costs, lease acquisition costs and royalty.

Thus, the Commission, while purporting to recognize the need for an incentive to the producing industry to search for additional supplies, has not only deprived the producers of the incentive to conduct further exploration, but also failed to meet the legal standards of *Bluefield* and *Hope*. Simply stated, even if the producing industry were given the opportunity to earn a 12 percent rate of return, the industry will not be able to compete successfully for investment funds which have the opportunity of earning a higher return in other regulated and non-regulated activities involving much less risk.

B. *The Commission Erred In Adopting A Minimum Rate Of Only 9 Cents And Subjecting Such Minimum To Quality Deductions.*

In the Permian decision, based on its interpretation of the decision by this Court in *Federal Power Commission v. Sierra Pacific Power Company*, 350 U.S. 348 (1956), the Commission established a minimum area rate, applicable to all gas, of 9 cents, but reduced the minimum

even further by subjecting it to quality deductions. (R. 669d-671d). It is Mobil's contention that the decision of the Commission to impose a minimum rate is just and reasonable, but that the 9 cent level is not supported by the record in these proceedings, and that the minimum should be placed at a level which will allow recovery of the revenue requirements which the Commission has established.

As the Commission in its Brief to this Court has correctly noted, the decision by this Court in *United Gas Pipe Line Co. v. Mobile Gas Service Corporation,* 350 U.S. 332 (1956) held that under the Natural Gas Act rate regulation is superimposed on, not substituted for, private bargaining. (Comm'n. Brief, p. 93). However, by the minimum rate order the Commission has abandoned any pretense of basing minimum rates on individual contracts, allowing unilateral producer filings up to the designated minimum. (R. 671d). Thus, if the Commission is to abandon contract restrictions in allowing producers to file up to the designated minimum, then the minimum rate level chosen should be supportable from the record before the Commission and should form a part of a rate design which will allow recovery of revenue requirements.

In setting a minimum the Commission emphasized that *Sierra,* decided by this Court on the same day as *Mobile,* recognized that the Commission possesses the power to authorize rate increases despite contractual limitations. However, *Sierra* also held that the Commission must base such authorization on more than a "bad bargain" by the producer with the pipeline purchaser, which has resulted in a low rate. Rather, this Court stated:

> [T]he sole concern of the Commission would seem to be whether the rate is so low as to adversely affect the public interest—as where it might impair the financial ability of the public utility to continue its service, cast upon other consumers an excessive burden or be unduly discriminatory. 350 U.S. at 355.

The Commission concluded that the test of raising rates above contractual limitations must therefore rest on public rather than private considerations and that "the examples set forth by the Court are not, and were not intended to be, the only instances where public interest would justify an authorization to increase rates in contravention of a contract." (R. 670d). The Commission determined that a minimum rate was in the public interest because

> The rate received by a producer must not be so low as to prevent or retard further exploration and thereby decrease possible discovery of gas reserves which will be needed by consumers. (R. 671d).

The Commission stated that the impact of its 9 cent rate would be *de minimus* on consumers, but would perhaps encourage producers with low contract rate ceilings to continue to search for gas.

Whether this Court adopts or rejects Mobil's position that the Commission's dual rate structure is invalid, it is obvious that the maximum area rates which the Commission has developed based on averages of certain items of industry cost[4] are the Commission's revenue requirements

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4. Mobil has objection to the exclusion of processing and gathering charges in the items considered in determining maximum area averages, which would in and of itself place industry averages at a higher level.

for the industry in the Permian Basin. In order to allow recovery of these revenue requirements, since regulation under the Act is "superimposed" on contract rates, the Commission should adopt a minimum rate which will allow recovery of this industry revenue requirement. Considering the fact that not all contracts allow rates at or near the area maximums determined by the Commission but many at rates substantially lower than the maximums, considering the fact that rate increase filings above the area maximums should be allowed,[5] and considering that contract rates presently above the area maximums are to be lowered to those maximums, the area minimum should be determined from substantial evidence in the record which will insure that a producer has the opportunity to earn the industry revenue requirements under his applicable contract rate. Mobil submits that the 9 cent minimum adopted by the Commission does not fulfill this need. The only justification for the 9 cent figure is that its effect on consumers is *de minimus*. The Commission itself estimates that "at the most $250,000 annually" (R. 671d) will be produced. The reduction in contract rates presently above the area level should more than counterbalance this figure. Considering the requirement under the Natural Gas Act that rate regulation is to be superimposed on contract rates with the need to allow producers to recover the revenue requirement in the Permian area, the Commission should be directed to reconsider the minimum rate level with a view toward establishing a minimum which will allow recovery of the revenue requirements for the Permian area.

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5. Mobil has objected to the imposition of a general moratorium on such filings and the permanent proscription of filings based on flexible pricing clauses.

C. *The Exemption Which The Commission Provided From The Applicable Area Rate Is Inadequate And Not In Conformity With The Statutory Scheme Of Ratemaking Required By The Natural Gas Act.*

Clearly recognizing that the Permian decision must make provision for an aggrieved producer to seek exemption from the applicable area rate, the Commission provided that where producers who have *contracted* for "an above ceiling price" can show out-of-pocket expenses in connection with the operation of a particular well above the revenues received from the applicable area rate, "appropriate relief" will be granted. (R. 658d). The Commission also noted that there may be other situations where "appropriate relief" should be granted as a matter of law or in the public interest but refused to "specify all of the special circumstances." (R. 658d)[6] "Appropriate relief" was further defined to indicate that in most cases "it may be sufficient to permit them [producers] to abandon their unprofitable sales." (R. 658d-659d). In a proceeding which has determined maximum area rates from nationwide or area averages of certain items of cost incurred in gas production, the Commission's reliance on "individual well cost" seems a rather inadequate exemption provision for the individual producer and one presenting difficulty administratively.

The Commision's exemption provision is further complicated by the separate provisions of the Permian decision applying a moratorium on all contractually allowable rate increases above the maximum area rates for a specified

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6. The Commission also stated that refunds would not be required if a producer in so doing would be deprived "of amounts sufficient to cover his out-of-pocket operating expenses in the Permian Basin for such period." (R. 660d).

period, and permanently prescribing rate filings above the maximum area rates based on certain flexible pricing clauses. These provisions have previously been discussed in the first portion of this argument. Considering these provisions, should a producer experience rising costs that have been anticipated through contractually allowable rate increase filings, then because of the Commission's moratorium or its prescription on flexible clauses a producer may be unable to file for a rate higher than the maximum area rate and seek exemption from the area rate. Thus, the Commission's exemption is only applicable at present to those producers who have contract rates that are presently above the maximum area rate, and which are not in effect subject to refund. During the period of the moratorium, no contractually allowable rate increases are to be allowed above the area maximums. Even after expiration of the moratorium, filings based on flexible clauses are prohibited. As the Commission correctly stated "This Court held in *United Gas Pipe Line Co. v. Mobile Gas Service Corp.*, 350 U.S. 332, that under the Natural Gas Act rate regulation is superimposed on—not substituted for private bargaining." (Comm'n. Br., p. 93). A producer who has a contractually allowable right to file for a higher rate, which higher rate may prevent confiscation and cover rising costs, will be denied such contract right, aside from the adequacy of the Commission's exemption provisions, during the moratorium period or permanently if the contract right is by flexible pricing clauses.

The maximum area ceilings adopted by the Commission are equal to the sum of the averages of certain items of cost incurred in producing gas which the Commission felt should be considered in pricing gas on an area basis. By the very nature of an average, such ceilings will only

provide for the recovery of production costs for that gas having average or below average costs. By the very nature of an average, a large percentage of Permian gas has and will have above average costs. Yet in allowing for relief if "out-of-pocket expenses" are greater than applicable area rates, the Commission fails to explain what costs are to be considered as "out-of-pocket expenses." This presents a regulatory standard that is impossible for a court to review or for an aggrieved producer to meet. Further, the Commission's brief to this Court makes clear that these "out-of-pocket expenses" are not to be individual costs "since relief on such a ground would resurrect the rejected company-by-company approach and make the area rate a floor rather than a ceiling." (Comm'n. Br., p. 66). This reasoning by the Commission ignores the often repeated principle that confiscation is an individual consideration. *Chicago & N.W. R. Co. v. Atchison T. & S.F. R. Co.*, 18 L. Ed. 2d 803, 815, 829 (1967); *New England Divisions Case*, 261 U.S. 184, 204 (1923). An exemption provision is included to prevent confiscation of the individual's property by rates based on group requirements.

Further, the basic remedy of abandonment proposed by the Commission is deficient for at least two basic reasons. First, the proper function of an exemption provision in group ratemaking is not to force a choice between offering a service or a commodity at certain prescribed rates or not at all. Rather, the proper function of an exemption provision in group ratemaking is to allow a continued offering of a service or commodity but at rates which will not be confiscatory where the applicable group rate will be confiscatory. As this Court has noted in other instances of group ratemaking, an exemption provision

should always be available to allow for modification of the rate order, thus allowing continued service. See *Chicago & N.W. R. Co. v. Atchison T. & S.F. R. Co., supra; New England Divisions Case, supra; King v. United States,* 344 U.S. 254, 275-276 (1952) Second, if abandonment of interstate sales is to be allowed in all confiscatory situations, the interstate market may be deprived of substantial quantities of gas. As this Court has observed on many occasions, the primary purpose of the Natural Gas Act was to provide protection to the "ultimate consumer." See *Phillips I,* 347 U.S. at 685. It does the ultimate consumer little or no good to have a gas supply committed to interstate service abandoned. The continued protection of consumer interests demands an adequate and stable gas supply. The abandonment provision in the Natural Gas Act, as in all regulatory statutes, was included to assure that the public would have continued and reliable service which could only be abandoned when no longer justifiable in the public interest. Certainly the Commission may not be allowed to say that it is not in the public interest to allow gas having above average costs to be sold interstate. The allowance of rates which are not confiscatory to the party offering regulated services or commodities is not in degradation of the public interest. Further, from the standpoint of the individual producer, abandonment of interstate sales in the Permian Area offers little or no relief since most area wells and reservoirs have no alternative non-jurisdictional markets available for immediate connection. Under applicable State property law, this cessation of production could well result in a loss of producing properties or substantial damage claims from royalty owners. Finally, the inequities and the possible damage to the public interest resulting from abandonment have been previously noted and

rejected by the Commission itself. *Amerada Petroleum Company*, 24 F.P.C. 218 (1963).

The Commission attempts to refute the proposition that when a producer seeks exemption from the area rate, the applicable area rate should be stayed and the producer allowed to collect the contract rate which he is attempting to justify. (Comm'n. Br., pp. 67-67). Basically, the Commission asserts that the stay of an adminstrative order is not automatic, but must be justified by a substantial showing. Such a showing is possible where a producer seeks exemption from the applicable area rate. Should the area rate not be stayed pending determination of the confiscation issue and should the issue of confiscation prove valid, the increased rate which would have been collected during this interim period is irrevocably lost, since as this Court noted in *Hope* and *Callery* the Commission "has no power to make reparation orders." 382 U.S. at 229. The loss of such revenue will but compound the impact of confiscation. Should the issue of confiscation prove invalid, the consumer will be adequately protected by the refund procedure.

The Permian exemption provision demands additional consideration and thought by the Commission.

D. *The Commission Erred In Ordering Producers, On The Basis Of Their Individual Contracts, To Refund All Amounts Collected Above Applicable Area Rates As To Each Contract Subject To A Section 4(e) Proceeding.*

Having determined the maximum ceilings for area rates and having outlined the procedure to determine the amount of quality deviations to be subtracted from the maximum to give applicable area rates, the Commission then ordered refunds for collections above the resulting

applicable area rate made prior to its decision if made under a contract subject to a Section 4(e) proceeding. Should this Court uphold the Commission in relation to the area rate levels, the Commission has still erred in regard to this refund order. The refunding obligation is to be effective from the date the Section 4(e) proceeding was instituted and is to include both the 4(e) increase as well as the rate formerly collected. (R. 672d, 674d). The Commission is thus requiring a refund below the level of that rate in effect prior to the institution of the 4(e) increase procedure. In so ordering, the Commission has engaged in retroactive ratemaking, which this Court has clearly indicated is beyond its power under the Natural Gas Act.

By way of illustration, if in 1964 a Permian producer were collecting a 16 cent rate permanently certified in 1958, the 16 cent rate would be referred to as a "last clean rate"; that is to say, a rate permanently in effect not subject to refund. If in 1964 the producer filed a contractually allowable rate increase of 1 cent, assume that the Commission suspended the increase under Section 4(e) but upon producer motion it was placed in effect subject to refund five months later, and has been collected to date. The 17 cent rate presently being collected by the producer is thus divided into two parts: the 16 cents collected prior to the rate increase which the Commission has previously allowed without refund liability through permanent certification; and the 1 cent increased incrument placed into effect under the procedures of Section 4(e), which have allowed the increase to be collected subject to refund, pending a determination of its justness and reasonableness. Assume also that the gas sold under the contract must be processed to bring it up to "pipeline standard" and that the purchasing pipe-

line and the producer agree that this processing charge should be 1 cent per Mcf. The applicable area maximum would be 14.5 cents and the 1 cent charge would be subtracted from it giving an area rate of 13.5 cents. Therefore, the hypothetical producer would be required to refund 3½ cents of the present 17 cent rate from 1964, the date of the 4(e) increase, to the present. This would include not only the 1 cent increased increment which has been collected subject to refund but in addition 2½ cents of the 16 cent rate permanently certified by the Commission in 1958. Should this Court uphold the Commission's Permian area rate levels and the quality deductions there is no question that a refund from 1964 to the present of the 1 cent 4(e) increased increment collected subject to refund is proper. Further, since the Permian proceeding is a Section 5(a) rate proceeding, there is no question but that the Commission can if otherwise allowable prospectively order refund of the difference between the 17 cent rate and the applicable area rate of 13½ cents from the effective date of the Permian Decision, September 1, 1965 to the present. What Mobil contends is improper is the Commission's attempt to order refund of the 2½ cent difference between the 16 cent rate permanently certified in 1958 and the 13½ cent applicable area rate from the 1964 date of the 4(e) increase down to the effective date of the Permian order on September 1, 1965. Since a permanently certified rate may only be reduced prospectively, by a 5(a) proceeding, the 16 cent rate permanently certified in 1958 may only be refunded in whole or in part after September 1, 1965.

This Court has previously addressed itself to the general problem of retroactive ratemaking by the Commission. In *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591 (1944), this Court stated:

> It is conceded that under the Act the Commission has no power to make reparation orders. And its power to fix rates admittedly is limited to those "to be thereafter observed and in force." 320 U.S. at 618.

As previously discussed in the section of this Brief dealing with the Commission's Permian moratorium, the Court has dealt extensively with the authority granted to the Commission by Section 4(e) of the Act. In *Sunray Mid-Continent Oil Company v. Federal Power Commission*, 364 U.S. 137 (1960), this Court dealt with the authority of the Commission if a hearing had not been concluded between suspension and the expiration of the five-month period.

> If the hearing were not concluded by the end of the suspension period, the increased rate could be collected ad interim but the Commission is empowered to require the company to collect the *increment* [the increase] under bond and accounting, and refund it [the increment] if it [the company] could not make out its case for the increase. 364 U.S. at 145. (Emphasis added).

The Commission may not dispute the authority given under Section 5(a). In *Atlantic Refining Company v. Public Service Commission of New York*, 360 U.S. 378 (1959), this Court stated:

> Under this section, however, the rate found by the Commission to be just and reasonable becomes effective prospectively only. Gas purchasers, therefore, have no protection from excessive charges collected during the pendency of a §5 proceeding. 360 U.S. at 389.

The prospective effect of Section 5 is illustrated by the statutory language that rates fixed thereunder are "to be *thereafter* observed and in force."

With the granting of a permanent certificate under Section 7, the Commission can only institute review of the certified rate under a Section 5 proceeding. As this Court observed in *Federal Power Commission v. Hunt*, 376 U.S. 515 (1964):

> Once a permanent certificate is granted the Commission can correct an improper rate *only* under §5 of the Act. . . . 376 U.S. at 521. (Emphasis added).

Thus, if a rate is permanently certified at 16 cents, the Commission may not review the 16 cent level until it institutes a Section 5 overall rate investigation. At the conclusion of the Section 5 proceeding, if 13.5 cents is the resulting just and reasonable rate, then prospectively the 16 cent rate is reduced to 13.5 cents, with *no* refund of the 2-1/2 cent difference already collected since the foregoing principles are undisputable. The question remains as to what effect the institution by a producer of a Section 4 increase for a rate above the 16 cent permanently certified rate has on the permanently certified 16 cent level. The Commission admits that Section 4 gives no refund authority prior to the date a producer institutes a Section 4 increase. Therefore, prior to the institution of the 4(e) increase, the 16 cent rate is not subject to refund. What the Commission attempts by its refund order is to allow the refund power of Section 4 to extend to a portion of a rate which is not being collected under any power granted by Section 4(e). The Commission is attempting to extend the refund power of Section 4(e) beyond the increase in rate placed in effect under 4(e). The Commission is attempting to abrogate the clear holdings of this Court that a permanently certified rate may only be reduced prospectively at the conclusion of a Section 5 proceeding.

In *United Gas Improvement Company v. Callery Properties, Inc.*, 382 U.S. 223 (1965), the Court reiterated this interpretation in relation to an in-line initial price.

> The fixing of an initial "in-line" price establishes a firm price at which a producer may operate, pending determination of a just and reasonable rate, without any contingent obligation to make refunds should a just and reasonable rate turn out to be lower than the "in-line" price. 382 U.S. at 227.

The State of California urges (Calif. Br., pp. 57-58) that the language of Section 4(e) allows the Commission to order a refund of both the increase and any portion of the "last clean rate" which is above the applicable area rate by reason of the language in Section 4(e) to the effect that after the Commission has determined a rate it

> [M]ay, . . . order such natural-gas company to refund, with interest, the portion of such increased rates or charges by its decision found not justified.

The contention, therefore, is that "increased rates" in the above quoted section refer to both the suspended increase as well as any portion of the "last clean rate" above the applicable area rate. Other than the interpretation of the statutory language as requested, no other authority is cited to this Court.

As discussed previously, this Court has stated that, as was conceded by the Commission in 1944, the Natural Gas Act gives the Commission "no power to make reparation orders." Also this Court has held that Section 5(a) has prospective application only and once a rate has been permanently certified by the Commission under Section 7, it may be altered only by a 5(a) proceeding. Section 7,

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as this Court has recognized in *CATCO*, *Hunt* and *Callery*, has no refund procedure. Neither does Section 5 have a refund procedure. However, Congress has provided for consumer protection in the case of rate increases above the level previously certified or approved by requiring that when a rate previously certified under Section 7 or previously approved under Section 5(a) is to be changed, the Commission must determine if the increased rate is just and reasonable. But should this determination be delayed, the increase may be placed into effect, but subject to refund. Later if the increase is not just and reasonable in whole or in part, it will be refunded in whole or in part. These are the powers given to the Commission under Section 4. To allow the Commission to go behind the Section 4(e) refundable increase destroys the structure of the Act, and ignores almost a decade of decisions by this Court on the ratemaking and charging provisions of the Act.

E. *The Issue Of The Automatic Application Of The Area Rate To Initial Certifications Under Section 7 Should Not Be Decided By This Court.*

Concurrent with its Permian Decision, by a separate Order Issuing Certificates (R. 798d, R. 827d-839d), and by Modifications of that Order (R. 1133d-1136d), the Commission issued permanent certificates of public convenience and necessity under Section 7 of the Act in four applications consolidated in the Permian procedings. One of these, Docket No. CI 61-34 is a Mobil sale which prior to the Commission's order was being made under temporary certification at 17 cents subject to a refund floor of 11 cents. The Commission, following its decision in Opinion 468, made the applicable area rates of that deci-

sion also applicable to these initial certifications. (R. 827d-828d). In the case of Mobil this is a 14.5 cent rate, subject to quality deductions.

In Opinion 468, the Commission held that its Permian orders would be applicable to "all sales of respondents whether they were being made at the time we instituted this proceeding or were begun subsequent thereto." (R. 683d). In response to the contention that the Permian rate determinations could not apply to contracts filed after Permian was instituted, the Commission felt that any other holding "would require an unending succession of Section 5 area rate proceedings, each covering only the sales instituted prior to the institution of the proceeding." (R. 683d). The Commission had previously noted in regard to its Permian Decision that:

> This proceeding, instituted under Section 5(a) of the Natural Gas Act, will determine the just and reasonable rates to be hereafter observed and in force for all jurisdictional sales being made under respondents' rate schedules. (R. 683d).

Therefore, the Commission felt that "Consistent with the provisions of Section 5(a) of the Act, our Order will apply to all of respondents' sales in the described area. (See *United Gas Co. v. Mobile Gas Service Corp.*, 350 U.S. 332, 341 (1956))." (R. 684d).

The Tenth Circuit, because of its reversal of the Commission's determination of the applicable area rates, refused to decide the issue, and remanded the Order to the Commission stating:

> We note that in its disposition of this particular docket the Commission took the position that an

established area rate automatically becomes the in-line rate for a §7 proceeding. The same position was taken by the Commission in its Opinion No. 484 which we are today reversing by our decision in Nos. 8723 etc.—Phillips Petroleum Company, et al., v. Federal Power Commission, ... F.2d . . . . . We there hold that in a §7 application heard by the Commis-[fol. 140] sion after its Permian decision the adoption of the area rate as an in-line rate must fall because we have rejected the area rate. We do not there, and we do not here, express either approval or disapproval of the principle that an area rate established in a §5 proceeding automatically becomes an in-line rate for a §7 proceeding. The validity of such a principle may be affected by the final determination of the validity of the Permian Basin area rate. (XII R. 87-88).

In its Brief to this Court, the State of California (No. 100) urges approval of the Commission's order for the reason that should the Commission's decision be reversed or altered there would be "further delay in the development of area rate making." (Calif. Br., p. 62). The Brief of the California Gas Distributors also urges to this Court that the area rate should become an "in-line" rate for certification purposes. (Calif. Gas. Br., p. 39).

Concurrent with this Order, the Commission instituted a Show Cause Proceeding (R. 37s) in which it consolidated all rate increases and initial certifications not included in the Permian proceedings. The Commission directed all consolidated parties to "show cause" why the principles of the Permian Decision should not be made applicable to the consolidated procedings. It was of course necessary for the Commission to institute a separate proceeding for the dockets not consolidated in Permian in order to comply with the hearing provisions of the Natural

Gas Act. The Commission has taken no further action in regard to the Show Cause Proceedings, and no hearing has been held or yet scheduled.

Also, relevant to this issue, are the Petitions for Certiorari now pending before this Court in Nos. 373, 380, 385, October Term, 1967 dealing with the Commission's Opinion 484 issued subsequent to its Permian Decision. In Opinion 484, the Commission issued permanent certificates under Section 7 by automatically applying the area rates determined in Permian[7] in certificate applications not included in the Permian Decision nor included in the Show Cause Order discussed in the preceding paragraph. In reviewing Opinion 484, the Tenth Circuit adopted virtually the same position as it had in Permian, stating:

> When area rates for the Permian Basin receive final judicial approval, the issue presented here will be ripe for decision. If we were to decide them now, we would be rendering an advisory opinion. We now decide only that the rates fixed by Opinion No. 484 and accompanying orders are disapproved because they are based entirely on the Permian area rates which we have rejected. 377 F.2d at 279.

Thus, in this proceeding, as in the proceedings reviewing Opinion 484, the Tenth Circuit, because of its rejection of the Commission's Permian rate did not decide the issue of whether the area rate may become the rate automatically applicable to initial certification under Section 7.[8] As has been urged in this Court's review of Opinion

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7. As indicated by the various Petitions and Response, there are additional issues in the proceeding.

8. Again, as noted previously, there are other and different issues in Opinion 484 which the Tenth Circuit did not decide.

484 on Nos. 373, 380, and 385, October Term, 1967, the disposition of this issue should be in one of the two following procedures.

First, should this Court affirm the Commission in its Permian Decision, which Mobil for the various reasons set forth in this Brief contends the Court should not, then this issue, the issue of the automatic adoption by the Commission of an area rate as the rate applicable in subsequent Section 7 initial certifications, should be remanded to the Tenth Circuit for that court's decision. In affirming the Commission this Court will approve the area rate, thereby enabling the Tenth Circuit to consider the issue which it refused to consider since it felt the area rate was improperly decided. Opposition to this procedure is expressed by State of California (Calif., Br., p. 62), as being "further delay in the development of area rate making." The contention is also made that a remand by this Court would diminish consumer protection. This is far from true as is illustrated by Mobil's docket. Sale is being made under temporary authorization subject to refund down to 11 cents when a permanent certificate is issued. This offers complete consumer protection. Further, for this Court to decide the issue reserved by the Tenth Circuit in Permian as to the adoption of the area rate in all initial certifications would deprive Mobil of the review guaranteed by Section 19(b) of the Act, and would require this Court to proceed *de novo* into a complex issue and record without the benefit of an opinion by the Tenth Circuit. The course of action proposed by the California Brief would thus be violative of this Court's general practice not "to review an administrative record in the first instance." *United States v. Great Northern Railroad Company*, 343 U.S. 562, 578 (1952). See also *Seaboard Air Line Rail-*

road Company v. United States, 382 U.S. 154, 157 (1965).

Second, should this Court reverse the Commission in whole or in part, then the issue of the applicability of the area rate to initial certifications should be remanded to the Commission, along with the remainder of these proceedings, for consideration of this issue in light of this Court's opinion. The Commission has determined its answer to this issue based on the present Permian Decision. A change in the structure of the Permian Decision may well mean a change in the Commission decision. A change in the Permian Decision may well change the objections of producers to the position advocated by the Commission. Should this Court attempt to decide whether the applicable area rate is to be automatically applied in all initial certifications would again require this Court to review an administrative record in the first instance.

Rather, this issue should be remanded either to the Tenth Circuit or to the Commission. Should an appeal follow from the decision reached either administratively or judicially, then this Court can exercise appellate review over that decision.

CONCLUSION

For the reasons stated herein, Mobil submits that the Commission's Permian decision and accompanying orders should not be sustained in their entity but that these proceedings should be remanded to the Commission for altera-

tion in accordance with the positions advanced by Mobil herein.

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October, 1967

MOTION FOR LEAVE TO FILE BRIEF AMICUS CURIAE

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1967

Nos. 90, 95, 98-102, 105, 117, 181

THE PERMIAN BASIN AREA RATE CASES

On Writs of Certiorari to the United States Court of Appeals for the Tenth Circuit

MOTION FOR LEAVE TO FILE BRIEF AMICUS CURIAE ON BEHALF OF THE ASSOCIATED GAS DISTRIBUTORS GROUP

The Associated Gas Distributors Group (AGD)[1] respectfully moves for leave to file a brief *amicus curiae*. In support of such motion,[2] AGD respectfully states as follows:

I

The AGD companies provide public utility gas service to 11,000,000 customers in Alabama, Connecticut,

[1] AGD is an unincorporated group of public utilities (or in one instance a municipally owned plant managed by a public utility) engaged in the distribution of natural gas. The membership of AGD, for the purposes of this Brief, is listed on the inside cover of this Motion.

[2] Because of the number of parties herein and because our *amicus* brief was opposed in the court below by various producer interests—petitioners and respondents herein—we did not seek unanimous consent to file this *Amicus* Brief.

Delaware, District of Columbia, Georgia, New Hampshire, Maryland, Massachusetts, New Jersey, New York, North Carolina, Ohio, Pennsylvania, Rhode Island, South Carolina, Virginia and West Virginia. They rely upon gas supplies produced and transported in interstate commerce by natural gas companies regulated by the Federal Power Commission.

Certain members of AGD sought and were denied the right to participate as parties in AR61-1,[3] a denial which the Commission later admitted was inappropriate.[4] AGD has taken an active role before the Commission, representing the interests of gas distributors in each of the producer area rate proceedings which have been instituted since the instant *Permian* proceeding. It has been permitted to participate herein as *amicus curiae* in the Commission's review of its Examiner's Decision and before the court below; unless it is now permitted to participate here as *amicus curiae,* its interests will not be represented.

While the *Permian* order here under review fixes just and reasonable rates for only about ten (10%) per cent of the natural gas sales subject to Commission jurisdiction, the court's decision here will, as a practical matter, significantly affect and may control the resolution of issues by the Commission and reviewing courts in other pending area cases in which AGD companies are parties, involving in total about 65 per cent of gas sales subject to the Commission's jurisdiction. (See Appended Chart)

The close relationship between the case at bar and

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[3] See Area Rate Proceeding, *et al.*, Docket No. AR61-1, *et al.*, 26 F.P.C. 193, 194 (1961).

[4] See Area Rate Proceeding, *et al.*, Docket No. AR64-1 *et al.*, 31 F.P.C. 888, 891 (1964).

the other producer area rate proceedings—and the basis for AGD's interest herein—is best illustrated by the facts pertaining to the *Southern Louisiana* proceeding where virtually the same major producers are involved as in *Permian;* the cost data were supplied by these producers for the same "test" year (1960); and substantial segments of the *Permian* testimony, of general industry-wide import—including the basic economic testimony supporting the cost-based, two-price method of regulation adopted by the Commission here—were incorporated *verbatim.* The Examiner's Decision in *Southern Louisiana,* which applies the general regulatory methods and principles adopted in the order now before the Court, calls for a prospective reduction in producer prices of some $55-60 million annually.[5] On the other hand, were the Commission to uphold the producers' claim for their contract prices, an increase in the current level of field prices in this area in the order of some $100 million annually would result.

Considerations of rate stability and regulatory certainty also give AGD an important stake in affirmance of the Commission order in this case. As this Court is aware, the development of an effective plan of producer regulation has been a major Commission problem since 1954.[6] Only now, after lengthy experimen-

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[5] The *Southern Louisiana* case, which was initiated on May 10, 1961, has been submitted to the Commission for decision after oral argument in May of 1967, but no decision has yet been issued. Since most of the gas flowing from the Southern Louisiana area is being sold under rates which are not subject to refund, the longer a decision is delayed the higher the level of economic injury to the consumer.

[6] The 1954 jurisdictional ruling in *Phillips Petroleum Co.* v. *Wisconsin,* 347 U. S. 672 (1954), established the basis for regulation of producers under the terms of the Natural Gas Act.

tation [7] is a workable system of regulation at hand; the reversal by the Tenth Circuit threatens a prolongation of the period in which unjustified producer prices will be collected to the irreparable damage of consumers.[8]

II.

The *amicus* participation of AGD, if approved, would provide the Court with a more balanced discussion by segments of the natural gas industry of the nationwide significance of the instant orders. The producer-petitioners and producer-respondents operate nationwide and have specifically raised issues concerning the applicability of the *Permian* principles in other area proceedings.[9] Having been active in the other area cases, AGD is in a unique position to discuss the present orders in the context of the total area rate program.

Accordingly, the AGD brief will bring to the Court's attention the point of view of a substantial segment of the gas industry, and the gas consuming public it serves, which is not otherwise represented here, which will not necessarily be advocated by any other party, and which is based on considerable experience in the other area proceedings now pending before the Commission.

WHEREFORE, for the foregoing reasons, AGD respectfully moves for leave to file a brief *amicus curiae* in

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[7] *Phillips Petroleum Co.*, 24 F.P.C. 537, 547 (1960), *aff'd sub nom., Wisconsin* v. *FPC*, 373 U. S. 294 (1963).

[8] The courts have repeatedly expressed concern over the "nigh interminable" delay in fixing just and reasonable producer rates. See *Atlantic Refining Co.* v. *Public Service Comm'n*, 360 U. S. 378, 389 (1959); *United Gas Improvement Co.* v. *FPC*, 287 F. 2d 159 (10th Cir. 1961).

[9] See, *e.g.*, Pet. of Continental Oil Co., *et al.*, p. 23.

these cases, and for all other proper relief in the premises.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1967

Nos. 90, 95, 98-102, 105, 117, 181

THE PERMIAN BASIN AREA RATE CASES

On Writs of Certiorari to the United States Court of Appeals for the Tenth Circuit

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BRIEF AMICUS CURIAE OF THE ASSOCIATED GAS DISTRIBUTORS GROUP

INTEREST OF AMICUS CURIAE*

The interest of the amicus curiae is set forth in the Motion to which this Brief is attached.

ARGUMENT

A. THE BASIC AREA RATEMAKING PRINCIPLES ADOPTED HERE SHOULD BE AFFIRMED.

AGD is vitally interested in the Commission's adoption of an effective method of producer regulation

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* The Opinions Below, Jurisdiction, Statutes Involved, Questions Presented, and Statement are set forth in the Petitioner FPC's Brief and will not be duplicated here.

which will end the "nigh interminable delay"[1] that has thus far attended the Commission's efforts to determine just and reasonable producer rates. The regulatory framework adopted by the Commission in its order under review goes far toward achieving this goal and we strongly urge its prompt affirmance by this Court. We specifically support:

1. The authority of the Commission to follow the area rate method.
2. The use of composite industry costs as the bedrock for area rate making.
3. The adoption of the cost-based, two-price approach to regulation (rather than a market-price approach) including the costing methods used to develop the cost of new and old or flowing gas.[2]
4. The special relief provisions made available to all producers.
5. The special treatment afforded small producers.
6. The imposition of reasonable rate-filing moratoria.

AGD's interest in supporting the above principles is not academic; tangible and substantial consumer benefits will flow from their application in the *Southern Louisiana* Area Rate Proceeding (Docket No. AR61-2)[3]

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[1] *Atlantic Refining Co.* v. *Public Service Comm'n*, 360 U.S. 378, 389 (1959).

[2] We agree generally with the cost allocation methods used by the Commission here, but do not agree that those methods should be limited to non-associated gas costs where evidence is available to determine all gas costs (see *infra*, pp. 11-17).

[3] In terms of both current and potential jurisdictional sales volumes, the Southern Louisiana area is the largest and most important single pricing area established by the Commission.

and in other area rate proceedings to which AGD is a party.[4] In the *Southern Louisiana* proceeding, for example, the Examiner's Initial Decision, issued in December 1966, has followed the precedent established by the order here under review and has established rate ceilings for that area of 19.5¢ per Mcf for new gas and 18.25¢ per Mcf for old gas.[5] As this Court is well aware, prices for gas produced in Southern Louisiana are higher and have increased more rapidly than have those in any other southwest producing area,[6] and the rates currently in effect—most of which are subject to prospective reduction only—are well above the levels prescribed by the Examiner in his Decision. Consequently, application to *Southern Louisiana* of the foregoing principles adopted by the Commission in its order here under review should eventually result in very substantial prospective rate reductions—in the order of some $50-$60 million annually.

Since these regulatory principles were adopted in full contemplation of their nationwide applicability to the gas-producing industry, it is reasonable to assume—as we do—that the Commission will apply them.

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[4] See Motion, *supra*, p. 1 pointing out that the millions of consumers served by AGD members are vitally affected by the rate-making decision here.

[5] For gas produced offshore, in federal waters, and not subject to the 2.3¢ Louisiana severance tax, the ceiling price is 1.5¢ per Mcf lower. Area Rate Proceeding, *et al.*, Docket No. AR61-2, *et al.*, Initial Decision, Slip Op., p. 276 (December 30, 1966).

[6] Thus, almost all of the initial-price cases to reach this Court have involved Southern Louisiana sales. See, *e.g.*, *Atlantic Refining Co.* v. *Public Service Comm'n.*, 360 U. S. 378 (1959); *United Gas Improvement Co.* v. *Callery Properties, Inc.*, 382 U. S. 223 (1965); *FPC* v. *Hunt*, 376 U. S. 515 (1964).

in the *Southern Louisiana* and other area rate cases.[7] We therefore urge the Court promptly and specifically to affirm these principles in its Decision here for the guidance of the Commission and reviewing courts in these subsequent cases.

With respect to the basic principles of area rate-making, which we have set forth above, the court below affirmed the Commission in all respects, except for the general provision for relief from area rates which it found inadequate. We believe that the court below was in error in this regard (*FPC* v. *Texaco,* 377 U.S. 33 (1964)) and urge that that principle, too, be affirmed. Further refinement of precise procedures for *relief* from area rates should, in any event, await the *imposition* of those rates for more than the 10 percent of jurisdictional sales involved in this case. We regard it as more important that area rates be established for the majority of all jurisdictional gas being sold in this country than that detailed procedures for exemption from those rates be provided for in advance of any demonstration that the Commission's provisions are inadequate. Furthermore, the courts may always review and correct arbitrary and unlawful action by the Commission in denying warranted relief; and the producers can scarcely claim to be aggrieved by the general clause provided in the order under review.

The remand ordered by the court below threatens still further delay in the application of the above principles to the *Southern Louisiana* area and the relief to consumers from the excessive rates now and for many

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[7] See, e.g., Brief for the FPC, pp. 46-48 in *Wisconsin* v. *FPC,* 373 U. S. 294 (1963); 1963 FPC Annual Report to Congress, pp. 122-23. See also Order on Review of Appeal from Presiding Examiner's Ruling Fixing Date for Staff Presentation of August 26, 1965, in Docket Nos. AR61-2, *et al.,* 34 F.P.C. 590, 591 (1965).

years being collected. This is so because the Commission has to date deferred action in *Southern Louisiana* pending events in *Permian* and may be reluctant to decide AR61-2 prior to judicial approval of the pilot case.[8] (See appended Chart.)

B. AFFIRMANCE OF THE ORDER HERE SHOULD FACILITATE THE APPLICATION OF COST-BASED RATES IN OTHER AREAS

In addition to our desire to see that the regulatory framework of the order under review be affirmed, our interest as *amicus* here is prompted by the fact that issues crucial to the *Southern Louisiana* case, but

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[8] We have repeatedly urged the Commission to expedite its *Southern Louisiana* decision. On November 4, 1965, we filed a "Motion for Omission of the Intermediate Decision or Adoption of the Interim Order Procedure." This Motion was denied on November 19, 1965. After acknowledging that the public interest required a prompt final decision in the proceeding, the Commission was nevertheless of the view that "the elimination of the Examiner's decision would not be conducive to . . . . [their] arrival at an early informed judgment" and noted that that Examiner "will be able to provide us with an initial decision within a short time after he receives the briefs from the parties." (Area Rate Proceeding, Docket No. AR61-2, 34 F.P.C. 1332, 1333 (1965). On December 30, 1966 the Examiner rendered his decision; and the case is now pending before the Commission. More recently, new filings have been made bringing rates substantially above in-line levels adopted in *CATCO* on remand. These filings were made on the expiration of five-year moratoria contained in settlement orders and in Commission decisions in "in-line" cases on the expectation that the Commission would decide AR61-2 within the moratorium period. [See *United Gas Improvement Co.* v. *Callery Properties, Inc.*, 382 U.S. 223, 226 (1965).] We requested the Commission to adopt an Interim Order Procedure and to allow rate increase filings only to ceiling levels determined by it on the basis of the *Southern Louisiana* record. The Commission has thus far not acted on this motion or our petition for rehearing which renewed it. It should be noted that the producers have strenuously objected to our expediting motions.

which we believe are not necessarily present here, may nevertheless—as a practical matter—be predetermined on the basis of the record here where AGD is not a party. Thus the remand ordered by the court below appears to be based on a concern that the rates fixed might not produce sufficient revenues to *recover* the costs found. Our concern with respect to the cases in which we are parties is with the converse, namely that an unqualified affirmance here might be interpreted as sanctioning rates which would produce revenues in *excess* of costs.

The court below, we think erroneously, held that the Commission order did not contain sufficient findings that producer revenues would be adequate to recover their costs. In its order denying rehearing, the Commission responded to producer contentions that the rate ceilings it imposed would produce a revenue deficiency (R. IX, 1112d-1116d). While for the reasons indicated in the order on rehearing, the Commission was unable in *Permian* to make a precise determination as to a cost-revenue balance, there is no similar impediment in other pending area cases; and it is our expectation that such a balancing will be forthcoming in such cases.

Since none of the companies in the AGD group purchases gas produced in *Permian,* we leave to the parties here the more definitive arguments specifically related to *Permian* and to the validity of the rates fixed by the Commission for that area. At the same time, we contend that there is a need to assure that the circumstances peculiar to *Permian* do not prejudice a decision in other cases where different circumstances prevail.

1. Rates Must Be Based Upon Costs, Not Commodity Value

The *Permian* order here under review leaves no doubt that it was adopting cost as "the bedrock" for area ratemaking. After rejecting both the commodity value basis urged by the producers and their claim that the reserves-to-production ratio indicated a threatened gas shortage which justified the contract rates, the Commission stated:

> If the area rate approach is to rest on a solid foundation, there must be an objective test by which the industry, the consumers and the courts can appraise the fairness of the price we fix. We are convinced that a composite cost determination is the bedrock on which a regulated price must be established. (R. X 573d)

The purpose of the Natural Gas Act is to prevent the producers of a product in limited supply from collecting exorbitant or windfall profits from captive customers. *Sunray Mid-Continent Oil Co.* v. *FPC*, 364 U.S. 137, 147 (1960). Determination of producer costs is necessary, as a "point of departure," to ascertain whether the existing level of field prices yields exorbitant, fair, or inadequate revenues when compared with financial requirements. *City of Detroit* v. *FPC*, 230 F. 2d 810, 819, (D.C. Cir. 1955), *cert. denied*, 352 U.S. 829 (1956).[9] In *Second Phillips*, the Court expressly noted assurances by the Commission that

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[9] Accord, *Mississippi River Fuel Corp.* v. *FPC*, 252 F. 2d 619 (D.C. Cir.), *cert.* denied, 355 U.S. 904 (1957); *Episcopal Theological Seminary* v. *FPC*, 269 F. 2d 228 (D.C. Cir.), *cert.* denied, 361 U.S. 895 (1959); *Bel Oil Corp.* v. *FPC*, 255 F. 2d 548 (5th Cir.), *cert.* denied, 358 U.S. 804 (1958); *Forest Oil Co.* v. *FPC*, 263 F. 2d 622 (5th Cir. 1959); and *United Gas Improvement Co.* v. *FPC*, 290 F. 2d 133 (5th Cir.), *cert.* denied, 368 U.S. 823 (1961).

composite costs would be considered in area ratemaking. 373 U.S. 294, 308, 310 (1963)

By adopting a regulatory approach bottomed upon cost, the Commission eliminated serious questions as to the legality of the resulting rates in this case, and the evidentiary basis for them. Had the Commission been free to prescribe rates for gas on the basis of non-cost considerations, an enormous breach would have been opened in the bulwark of consumer protection erected by the Natural Gas Act. Vague non-cost concepts such as "commodity value of gas" or "competitive market price of gas" tend to be subjective—their definition depends upon the background, experience and outlook of the economist or regulator using them. The regulatory discretion which would follow from their use as ratemaking standards would be as wide as the differences in viewpoint expressed by the producers, on the one hand, and the consumer interests on the other. Rate regulation under such a rationale, not being tied to any meaningful standard would, as a practical matter, be unreviewable.

2. Rates Should Produce Aggregate Revenues Which Are Not in Excess of Aggregate Costs

Our concept of cost-based regulation is that, even though non-cost factors might be considered in fixing rates, the aggregate revenues which such rates produce should not be materially in excess of the aggregate costs. In the other area cases, we contend that the determination of the average cost of all gas—and not simply the costing of non-associated gas—is possible, and necessary to a finding of whether the rates fixed produce revenues in excess of costs. We do not interpret the Commission's decision here—that it was unable *on this record* to establish a realistic cost of asso-

ciated gas—to preclude a determination elsewhere of *all* gas costs, (including both associated and non-associated gas) where adequate evidence is available. Since the cost of all gas is less than the cost of non-associated gas,[10] its use as a revenue standard has important consequences to consumers. Similarly we do not interpret the decision here to preclude the desirability of cost-revenue comparisons, where possible on the record. It should be noted that we do not disagree with the use of the higher cost of non-associated gas to fix price *ceilings,* and the uniform application of such ceilings to both associated and non-associated gas. Nonetheless, the cost of all gas provides the best standard to determine whether revenues for all gas, under area rates, are excessive.

In *Southern Louisiana,* the Examiner made no finding as to the cost of all gas; further, he recommended the addition of a one-cent, non-cost special incentive factor to new gas costs (which he determined to be 18.53¢ at a 12 per cent return and including 2.3¢ Louisiana severance tax).[11] We have taken exception

[10] The Commission held that such costing avoided certain allocation problems, largely peculiar to *Permian;* that the use of a single ceiling was less disruptive to existing contract practices for the sale of casinghead gas; and that, on the basis of the *Permian* record a "realistic" cost of oil-well gas—either as casinghead gas or residue gas—was not possible (R. X, 622d). Nevertheless the Commission found (R. XI, 1112d) the cost of associated gas (and, therefore, *all* gas) to be lower than the cost of non-associated gas. In *Southern Louisiana,* cost evidence submitted by AGD, the producers and the Commission staff showed the same, even under the varying costing methods proposed by the various experts.

[11] Because the new gas price is determined on the basis of the current and *future* costs of producing non-associated gas, the computation contains an inherent cost incentive. To this the Examiner adds a one-cent non-cost special incentive with no adequate rationale.

to these features of his decision. Whether increments to cost are labeled "special incentive factors," or "commodity value," whatever that vague phrase may mean,[12] the end result is the same—i.e., the imposition on consumers of a burden not justified to meet financial requirements of the producer (since these are already satisfied by costs) and not permissible under the Act. Yet this is precisely the result of the Examiner's rate design conclusions in that proceeding.

By contrast, the major gas producers in the *Southern Louisiana* proceeding contend that supply-demand trends and ratios "clearly signal the need for a non-cost adjustment [upward] in the range of 4-6¢ per Mcf if Southern Louisiana is to make its proper contribution to the producing industry's revenue requirements and realize the supply potential upon which the nation's gas consumers are relying."[13] The 4-6¢ non-cost adjustment of *Southern Louisiana* rates urged by these producers would result in substantial rate increases (perhaps in the order of $100 million annually compared with *existing* rates), rather than the reductions ordered by the Examiner. In consequence, in view of the conflicting views taken by AGD and the producers as to the rate design structure and level adopted by the Examiner, the issue of whether the Commission can authorize rates that produce aggregate revenues in excess of costs is of crucial importance in *Southern Louisiana*.

We therefore respectfully urge this Court to make it clear that its decision affirming the order here does

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[12] Cf. R. X, 614d.

[13] Area Rate Proceeding, *et al.*, Docket No. AR61-2, *et al.*, Indicated Respondents' Brief Opposing Exceptions, p. 19.

not authorize the Commission to permit rates that produce aggregate revenues in excess of aggregate costs, as they may be determined on the basis of the evidence in the area cases still pending.

CONCLUSION

The order under review represents the first major Commission determination of just and reasonable rates for producers after more than thirteen years of producer "regulation." At this stage of the regulatory history, three basic alternatives are presented to the Court:

1. Affirmance of the Commission order. This would permit implementation of area rates in other proceedings involving most of the gas subject to Commission jurisdiction.

2. Affirmance of the court below. This would delay implementation of the area rates for *Permian,* involve substantial additional litigation, and would probably delay Commission decisions in other areas.

3. Reversal of the Commission, and the court below, with respect to the basic principles of area rate regulation. The practical result of this would be to eliminate for the foreseeable future any feasible method of regulating producer prices as required by the Natural Gas Act.

We strongly urge this Court to affirm the Commission order in this landmark case. The Commission has laid out guidelines which will enable it to apply the area method to substantial volumes of producer sales in the very near future and which may be applied to the various areas where decisions are pending, with due regard to the factual differences established by

the records in those proceedings. The Commission should be given the opportunity to continue its area rate approach by affirmance of this order, so that the "nigh interminable delay" which is still descriptive of the determination of just and reasonable producer rates for the major producing areas of the country will finally be terminated.

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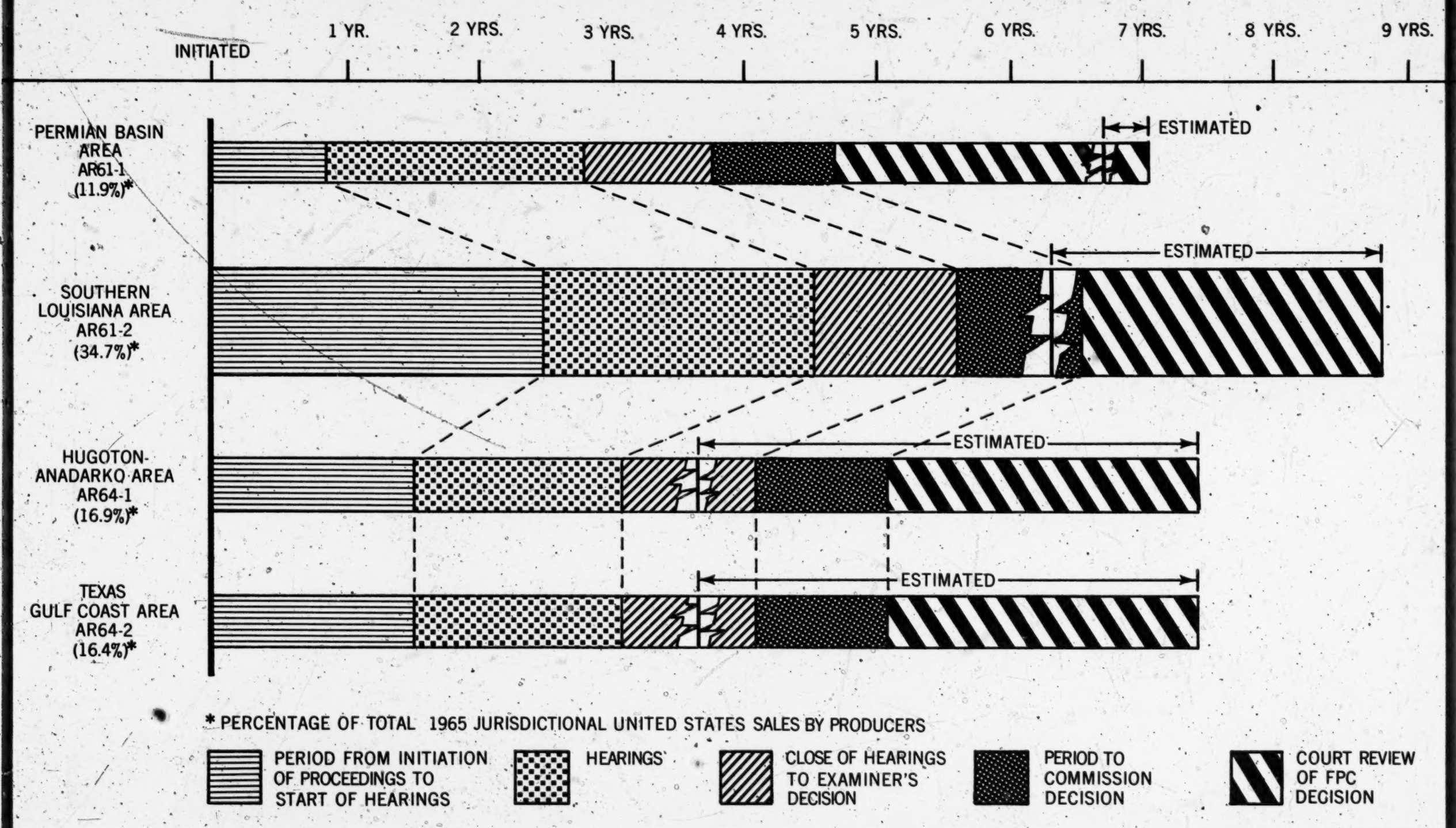
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August 31, 1967

COMPARATIVE CHRONOLOGY OF AREA RATE PROCEEDINGS



* PERCENTAGE OF TOTAL 1965 JURISDICTIONAL UNITED STATES SALES BY PRODUCERS

PERIOD FROM INITIATION OF PROCEEDINGS TO START OF HEARINGS

HEARINGS

CLOSE OF HEARINGS TO EXAMINER'S DECISION

PERIOD TO COMMISSION DECISION

COURT REVIEW OF FPC DECISION

MOTION FOR LEAVE TO FILE BRIEF AMICUS CURIAE

OCT 9 1967

FILED

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JOHN F. DAVIS, CLERK

Nos. 90, 95, 98-102, 105, 117, 181

IN THE

Supreme Court of the United States

OCTOBER TERM, 1967

THE PERMIAN BASIN AREA RATE CASES

On Writs of Certiorari to the United States Court of Appeals for the Tenth Circuit

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MOTION FOR LEAVE TO FILE BRIEF AMICUS CURIAE AND BRIEF AMICUS CURIAE FOR PHILADELPHIA ELECTRIC COMPANY

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October 9, 1967

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IN THE

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MOTION OF PHILADELPHIA ELECTRIC COMPANY FOR LEAVE TO FILE BRIEF AMICUS CURIAE

Philadelphia Electric Company (Movant) respectfully moves for leave to file a brief *amicus curiae* pursuant to Rule 42 of this Court. Movant's position is set forth fully in its brief. In support of this motion, Movant respectfully states as follows:

I.

Philadelphia Electric Company, Movant herein, is a public utility corporation engaged, *inter alia,* in the distribution of natural gas to approximately 250,000

consumers in the southeastern portion of Pennsylvania, comprising the counties of Delaware, Chester, Montgomery, Bucks, and a small portion of Lancaster County. Movant relies upon natural gas supplies transported in interstate commerce by natural gas companies[1] regulated by the Federal Power Commission which, in turn, purchase the major portion of their respective gas supplies from independent producers of natural gas, whose sales in interstate commerce are also regulated by the Federal Power Commission, many of which are respondents in this proceeding.

II.

As a public utility purchasing natural gas from pipelines which in turn purchase substantial amounts of gas from the southwest production areas of the United States, Movant has a substantial interest in the development and implementation of a legally sound, workable method of area rate regulation. The cost of purchasing or producing gas in the field is by far the largest single item of cost in any pipeline cost of service. Similarly, the cost of acquiring gas from the pipelines is the largest single item of cost in Movant's cost of service. Accordingly, the rates fixed for gas purchased in the field have a profound effect on the rates Movant must charge its customers. Movant thus has an important interest in the rate-making principles that will evolve from this initial area rate proceeding. The extent of this interest can be shown from the very substantial commitment Movant has made in time and money to assist the Commission in

[1] Transcontinental Gas Pipe Line Corporation and Texas Eastern Transmission Corporation.

developing a workable method of area rate regulation in the Southern Louisiana proceeding (AR61-2), now awaiting decision by the Commission, and the Texas Gulf Coast proceeding (AR64-2), now awaiting decision by the Examiner.[2] Movant has presented extensive evidence in the Southern Louisiana and Texas Gulf Coast proceedings in cooperation with other consumer interests and has also presented rate design evidence on its own behalf. The portions of the decision of the court of appeals to which the Commission's writ of certiorari is directed are in accord with Movant's position on rate design. Accordingly, Movant has an important interest in protecting its position.

III.

Although Movant buys no gas produced in the Permian Basin, Movant is nevertheless vitally interested in these appeals since the rates for natural gas paid to independent producers in the Permian Basin area will affect producers' overall revenues, and accordingly may be held to have a bearing on rates paid in other areas. Furthermore, this proceeding involves the first major Commission determination of just and reasonable rates for natural gas producers under the area rate method and will provide basic policy guidelines of general applicability to *all* producer sales in interstate commerce, including sales made in the supply areas which serve Movant.

IV.

Movant has actively participated in the proceedings involving supply areas serving Movant after having been refused intervention in this proceeding. Even

[2] Prior to the institution of the area rate proceedings, Movant had participated in all producer Section 5(a) proceedings.

though the Commission denied intervention to Movant in the instant proceeding,[3] it subsequently recognized the desirability of availing itself of the views of Movant and other eastern seaboard distributors in solving the complex problems inherent in area rate making and permitted Movant to file a brief *amicus curiae*.[4]

V.

The Commission recognized the importance of this first area rate case in its "Order Extending Time for Filing Exceptions and Replies Thereto and Fixing Date of Oral Argument," by stating that the instant proceeding

> ". . . is the lead case instituted by the Commission in its area rate program to establish just and reasonable rates which may be charged by producers of natural gas in various gas producing areas of the United States. We are confronted in this proceeding with legal, factual, and policy determinations of the greatest importance to both the producers and consumers of natural gas throughout the country."

Accordingly, Movant would respectfully request this Court to consider the views of Movant before committing itself to principles of regulation and a course of action in the instant proceeding which in all logic may be pursued with respect to other production areas. This is particularly true since the major producing companies that supply natural gas throughout the United States are in large part respondents in *both* the instant proceeding and the Southern Louisiana

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[3] *Area Rate Proceeding (Permian Basin)*, 26 FPC 193 at 194. (1961).

[4] *Area Rate Proceeding (Permian Basin)*, 32 FPC 1382 (1964). See also *Area Rate Proceeding (Hugoton-Anadarko)*, 31 FPC 888 at 891 (1964).

Area Rate Proceeding. These producers, who have contended that the final decision in the instant proceeding

> ". . . will undoubtedly set the course for future hearings and will affect the economic welfare of all segments of the gas industry and of the gas consumer,"[5]

are in a position to make their views known to this Court in this lead case and will undoubtedly discuss the regulatory principles at issue in this proceeding, having in mind the application of such principles in Docket No. AR61-2 and other areas.

VI.

If granted leave to file a brief *amicus curiae,* Movant would limit the scope of its argument to the requirement that the Commission, in establishing just and reasonable area rates, must make a determination of all costs and revenues in order to arrive at a proper balance and thereby meet the end-result test set forth in *F.P.C.* v. *Hope Natural Gas Co.,* 320 U.S. 591 (1944).

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October 9, 1967

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[5] Motion for Clarification of Decision of Presiding Examiner, pp. 1-2, filed October 12, 1964, by Humble Oil & Refining Co. *et al.* in Docket No. AR61-1.



IN THE

Supreme Court of the United States

OCTOBER TERM, 1967

Nos. 90, 95, 98-102, 105, 117, 181

THE PERMIAN BASIN AREA RATE CASES

On Writs of Certiorari to the United States Court of Appeals for the Tenth Circuit

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BRIEF AMICUS CURIAE FOR PHILADELPHIA ELECTRIC COMPANY

INTEREST OF AMICUS CURIAE

The interest of the *amicus curiae* is set forth in the Motion to which this Brief is attached.

ARGUMENT

Introduction

In the twenty-three years since this Court's landmark decision in *F.P.C.* v. *Hope Natural Gas Co.*, 320 U.S. 591, there has been little question under most regulatory statutes—and none at all in cases arising under the Natural Gas Act—that rates fixed by a regu-

latory agency are to be tested not by the method used in fixing them but by the end result; specifically, the question on review is whether the revenues produced under the rates fixed by regulatory action permit the recovery (but not more than the recovery) of the regulated entity's total allowable costs, both operating and capital. In the present case, the court below reversed the Federal Power Commission's order, essentially because it found that the Commission, in fixing rates for the Permian Basin, failed to match the producing industry's aggregate Permian revenues under area rates with the industry's total area costs.

We agree with the court of appeals that the Commission is required to balance costs and revenues, and we further agree with the court's finding that the Commission did not make such a balance here. We disagree, however, with the court's conclusion that the case should, at the instance of the *producers,* be remanded, for the record in this case makes unmistakably clear that the Commission's error, far from injuring the producers, actually benefited them at the expense of the consumer. Because a repetition of this error in the subsequent area proceedings (and four such proceedings, covering over 80% of all gas sold in interstate commerce, are now pending before the Commission) would compound the injury to the ultimate consumer, Philadelphia Electric Company, which will be directly affected by the other pending proceedings, respectfully requests this Court to hold that the Commission, by failing to make adequate cost and revenue determinations, denied itself the basis for making the end-result test required by *Hope.*

I. THE COMMISSION IS REQUIRED TO BALANCE COSTS AND REVENUES

To carry out "the intention of Congress that natural gas shall be sold in interstate commerce . . . at the lowest possible reasonable rate," [1] the Natural Gas Act specifically provides that "all rates . . . for . . . the sale of natural gas : . . shall be just and reasonable," [2] that "the burden of proof to show that [an] increased rate or charge is just and reasonable shall be upon the natural gas company," [3] and that "whenever the Commission . . . shall find that any rate . . . is unjust [or] unreasonable, . . . the Commission shall determine the just and reasonable rate . . . to be thereafter observed." [4] This Court has made clear that to determine whether a rate is just and reasonable it is necessary to determine whether the revenues produced by that rate are sufficient, but no more than sufficient, to provide for the operating and capital costs of the business, *F.P.C.* v. *Hope Natural Gas Co.,* 320 U.S. 591 at 603. Thus in *Hope* the Court noted that the return to the equity owner, i.e., the amount available from revenues after payment of all expenses and service on the debt, "should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital," *ibid.*[5] Once it is determined that the return to the equity owner is

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[1] 52 Stat. 825.

[2] Natural Gas Act, § 4 (a).

[3] Natural Gas Act, § 4 (e).

[4] Natural Gas Act, § 5 (a).

[5] Where more than this amount is permitted, the statutory requirement that a rate shall be "the lowest possible reasonable rate" is violated and windfall profits are granted the regulated entity, see *Atlantic Refining Co.* v. *Public Service Commission,* 360 U.S. 378 at 390 (1959).

at the appropriate level, however, "the end result [of the rate order] cannot be condemned under the Act as unjust and unreasonable *from the investor or company viewpoint*," *ibid.* (emphasis added).

In consequence, in virtually every rate determination that it has made under the Act, the Commission has first set out to determine the costs of the regulated entity, including a reasonable return on the necessary investment, and then has provided for rates which would produce the revenues needed to meet those costs.

II. THE COMMISSION FAILED TO BALANCE COSTS AND REVENUES

A. The Commission's Cost Determination

At the outset of the opinion here under review, the Commission rejected as inconsistent with the statutory standards the producer contention that rates could be fixed at the "market value" negotiated in producer-pipeline contracts and that, to maintain a ratio of proven gas reserves to annual gas production at some arbitrarily selected level, higher prices should be allowed. The Commission stated (Op. 468, 34 FPC 159 at 189-90):

> "If the area rate approach is to rest on a solid foundation there must be an objective test by which the industry, the consumers and the courts can appraise the fairness of the price we fix. We are convinced that a composite cost determination is the bedrock on which a regulated price must be established."

Having thus announced the correct rule of law, the Commission failed to follow that rule, for instead of making the "composite cost determination" for all gas produced in the Permian Basin, the Commission determined only the cost of gas-well or non-associated

gas (i.e., gas not associated with crude oil at the time of production), which, in the Permian Basin, accounts for but one-third of the total.[6] Although there were data in the record from which the cost of the other two-thirds might be determined—i.e., the cost of casinghead gas (including residue gas derived therefrom), which is associated with crude oil at the time of production—the Commission regarded such data as unsatisfactory and applied rates derived only from the cost of gas-well gas to all gas; surprisingly, the Commission made no attempt to reopen the record to obtain data it would regard as satisfactory.

In this connection, it should be noted that in a series of individual-company producer rate cases preceding its area determination here,[7] the Commission did in fact determine the cost of all gas, including casinghead and residue gas, and indeed in the present case the Commission staff made a determination of such cost consistent with the Commission's prior practice.[8]

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[6] Actually the Commission's error was even greater than the one-third figure would indicate, for the Commission did not cost all of the gas-well gas, but only the higher-priced portion (roughly 21% of *all* gas) derived from gas-well leases. The remaining gas-well gas—which has a lower cost (see Staff Exh. 170)—comes from combination leases.

[7] See, e.g., *Phillips Petroleum Co.*, Op. 338, 24 FPC 537 at 553 (1960); *Hunt Oil Co.*, Op. 365, 28 FPC 623 at 624 (1962); *H. L. Hunt*, Op. 369, 28 FPC 897 at 902 (1962); *Union Producing Co.*, Op. 414, 31 FPC 41 at 43, 48 (1964).

[8] The staff presentation was also consistent with the representation made by the Commission's General Counsel, and relied on by this Court, in *Wisconsin* v. *F.P.C.*, 373 U.S. 294 at 310 (1963), that "composite cost-of-service data will be considered in the area rate proceedings." In this proceeding, however, the Commission failed to consider composite cost-of-service data for 79% of the gas in the area.

Nor is there anything in the nature of area rate-making, as opposed to individual-company rate-making, that would justify a failure to find the cost of casinghead gas.[9] To the contrary, there are important collateral considerations which argue strongly that complete cost determination is essential under the Commission's program. A complete cost-finding procedure will permit the Commission to make a meaningful evaluation of individual claims of confiscation under the proposed "special relief" provisions; this will be all the more true where a particular sale is entirely of casinghead gas, or where a producer contends that his gas-well gas costs are atypically low.[10] Further, by finding a cost of all gas, including casing-

[9] In *Phillips Petroleum Co.*, Op. 338, 24 FPC 537 at 553 (1960), the Commission noted that the allocation method there adopted for determining the cost of casinghead gas was "particularly suitable for . . . a company such as Phillips where the number of leases and the geographical spread of operations provide a broad base for determining the unit costs of the separate products." *A fortiori*, the method should be applicable in industry-wide rate-making.

[10] Certainly, in such a "special relief" situation the Commission could not contend that imputing the cost of gas-well gas to casinghead gas is a satisfactory basis for determining the cost of the latter, for in *Phillips Petroleum Co.*, Op. 338, 24 FPC 537 at 553 (1960), it said:

> "We agree with the Examiner that the imputed cost method does not constitute a satisfactory basis for the determination of the cost of Phillips' casinghead and condensate gas produced in the Oil and Gas Production Department. The imputed cost method does not allocate Phillips' total costs. It merely assumes that the unit cost of the casinghead and condensate gas is the same as the unit cost derived from dry gas produced in the Panhandle-Hugoton Field without using or reflecting the actual cost of the joint product wells. Furthermore, it appears that the dry gas costs in the shallow Panhandle and Hugoton fields were the lowest gas production costs on the Phillips system."

head, the Commission would have available, as a difference figure derivable from the cost data filed by the producers, the cost of oil production; this, in turn, would enable the Commission to consider whether the relation between oil cost and revenue indicates that the cost it has allocated to gas is unreasonable, a contention which has been raised by many producers, see, e.g., *Tidewater Oil Co.*, 27 FPC 1267 at 1304-06 (1962).[11] In this latter connection, the Commission has very recently, and quite correctly, held that liquids must bear their fair share of joint costs, *Tennessee Gas Pipeline Co.*, Op. 528, September 26, 1967.

B. The Commission's Rate Design

Having determined the cost of gas-well gas, including a return computed at 12% on investment, the Commission used the resultant unit cost as a rate ceiling for all flowing gas. Discounts below, and in certain instances premiums above, this ceiling were fixed where the gas was below, or above, standard quality; in addition, if the producer had by contract agreed to a price below the ceiling, the rate to be charged under the Commission's order would, with certain exceptions,[12] be the below-ceiling contract rate. Although the aggre-

[11] The same data will also permit the Commission, in second-round area proceedings, to observe whether the unit cost it finds for gas appears to be changing in an unreasonable manner as contrasted to the unit cost of liquids. If the cost found for gas rises while that found for liquids falls or rises much less rapidly, it could indicate that, in their reporting, the producers were charging too great a share of total costs to gas. Given the importance and difficulty of setting rates for the entire industry, the Commission should not at the outset deny itself such a valuable check on the reliability and consistency of its determinations.

[12] The Commission directed that contract rates of less than 9 cents per Mcf be raised to a 9-cent minimum.

gate amount of these discounts, premiums, and contract price limitations were not known at the time of the Commission's order, the Commission was aware that the average unit revenue derived under the rates it was setting would be less than its ceiling level; and, as we show below, it deliberately set its ceiling above the average unit cost of all gas to compensate for this difference.

The court below, apparently under the mistaken view that the Commission's ceiling rate represented (or was required to represent) the industry's average unit cost, remanded the Commission's order because the average unit revenues produced under the ceiling were less than the ceiling.

III. THE COMMISSION'S FAILURE TO BALANCE COSTS AND REVENUES DID NOT INJURE THE PRODUCERS HERE

A. The Rates Fixed by the Commission Are Certain to Generate Revenues in Excess of Costs

The findings of the Commission, undisturbed by the court below, make clear that the rates fixed by the Commission will generate revenues materially in excess of the producers' area costs:

New Gas-Well Gas (dedicated under contracts dated 1961 and later)—The cost of new gas-well gas is based upon the current cost of finding, developing, and producing gas-well gas, utilizing recognized industry statistics and including a growth allowance and a rate of return of 12%. The Commission found that these costs have remained constant since 1960 (Op. 468, 34 FPC at 189), and it also found a trend toward increased realization of condensate and other natural gas liquids per Mcf of gas-well gas (34 FPC at 196), a factor which tends to *reduce* the cost attributable to gas.

All Flowing Gas (dedicated under contracts dated prior to 1961)—The Commission fixed its rate ceiling for all flowing gas by reference to the cost of flowing gas-well gas, despite its express finding (34 FPC 1068 at 1072):

> "the evidence in the record makes clear that with respect to casinghead gas and residue gas derived therefrom . . . the costs are substantially below the 14.5 cents per Mcf ceiling price." [13]

It necessarily follows that the Commission's failure to cost all gas, casinghead as well as gas-well, resulted in the Commission's finding a substantially higher unit cost than would have been found if all gas had been costed. The only factor which might interfere with producer recovery of full costs is the use of ceilings which would, as a result of quality deductions and contract limitations, produce unit revenues somewhat below the ceilings. Wholly aside from the fact, however, that the 14.5¢ ceiling for flowing gas fails to reflect the lower-cost casinghead gas, the following elements of the Commission's rate design more than offset this factor:

(1) In deriving unit costs, the Commission had allowed return on investment at 12%—approximately 5.6 cents per Mcf for flowing gas,[14] and even more for

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[13] This is, of course, to be expected. Since casinghead gas is a by-product of the search for oil, it would be unrealistic to assign large portions of exploration and development costs to it, 34 FPC at 190. Moreover, the gathering and processing of casinghead gas is aimed primarily at recovering liquids, 34 FPC at 209.

[14] This includes 4.99 cents per Mcf return on production rate base and 0.62 cents per Mcf return on exploration rate base, 34 FPC at 216 and 301.

new gas. In fixing the rate of return this high, the Commission expressly indicated that its intent was to "compensate for the risk of finding gas of less than pipeline quality" (34 FPC at 1072), i.e., to compensate for the lower price that gas of less than pipeline quality would bring.[15] The Commission further found that the quality adjustments would result in a reduction from the ceiling of from 0.7 cents to 1.5 cents per Mcf (34 FPC at 1073), thereby reducing the 5.6-cent-per-Mcf return allowance included in the unit ceiling to a realized return of 4.1 to 4.9 cents per Mcf, or a return on investment in the range of 8.8-10.5%, even with a *full* share of exploration costs assigned to casinghead gas, an assignment which the Commission found to be "unrealistic," 34 FPC at 190. The court of appeals did not deny that the Commission's use of a 12% return in fixing the ceiling price was the equivalent of an industry-wide realized return under the ceiling of 8.8-10.5%, and it did not find that a method which produces as its end result a return of 8.8-10.5% is unreasonable under *Hope*. Rather, the court below held that the Commission had erred in calling a pricing differential a "risk" cognizable in the return component, 375 F. 2d at 31. If the end result is just, however—and the court did not find that it was not—an alleged defect in the method does not warrant reversal.

(2) The higher (16.5¢) price set by the Commission for new gas-well gas had the purpose of providing an incentive for discovery and commitment of new gas reserves to interstate commerce, a function which oper-

---

[15] While we feel that quality variations can be more appropriately accounted for in rate design or cost than in rate of return, it would be difficult to characterize the Commission's approach as an abuse of discretion.

ates prospectively (34 FPC at 188-89; cf. 34 FPC at 273-74 (dissenting opinion)). Nonetheless, the Commission back-dated the higher price to January 1, 1961, thereby encompassing contracts executed for the five-year period preceding its decision and giving the producers the benefit of the regulatory delay. As a result, for all gas-well gas sold under contracts dated subsequent to the end of the test year (1960), the Permian producers are permitted to recover a price 2 cents per Mcf above the experienced test-year cost of finding and producing gas-well gas,[15a] even though some of the gas sold under these contracts may have been discovered well before the test period.

(3) Finally, the Commission made available to all producers a "savings clause" and specifically noted that, in the event that either its area price ceilings or policies created problems for a producer, a gas processor, or a pipeline purchaser, it would entertain applications for necessary relief. We believe that the court below was in error in holding the savings clause inadequate, *F.P.C.* v. *Texaco Inc.*, 377 U.S. 33 (1964); see also Brief for F.P.C., pp. 64-68; and until such time as the savings-clause procedure has been utilized, we believe that it is premature to hold that the producing industry lacks a reasonable opportunity to recover its costs as a result of the *Permian Basin* rate order.[16]

[15a] In this connection, see note 6, *supra*.

[16] The Commission's failure to cost all gas would have to be corrected, of course; otherwise the savings clause could be a delusion, see *supra*, p. 12.

B. Failure To Cost All Flowing Gas in Southern Louisiana Would Result in an Annual Overcharge to Consumers of $30,000,000

What the Commission has, in effect, said in *Permian* is that while it does not know what the producers' composite cost of service is, it does know that the rates it has established are at least adequate to cover that cost. But are the rates *higher* than necessary to cover that cost, and therefore *excessive?* If so, by what amount? The Commission cannot say.

In contrast to the ambiguity surrounding *Permian,* the precise (and baleful) effect of similar Commission action in *Southern Louisiana* has already become known. In that proceeding, the examiner, apparently feeling himself bound by the Commission's action in *Permian,* costed only flowing gas-well gas, even though the record contained the cost of all flowing gas determined in accordance with the methods used by the Commission in *Phillips* and adhered to until *Permian.* Following the Commission's action in *Permian,* the examiner in *Southern Louisiana* set his rate for all flowing gas at the level of the cost of flowing gas-well gas. Based on the difference in unit costs between flowing gas-well gas and all flowing gas applied to test year sales of 1,659,996,204 Mcf,[17] this would result in an increase in cost to the consumer of approximately $30,000,000 per year. In consequence, a number of the consumer interests, including Philadelphia Electric Company, have taken exception to the examiner's holding on this issue, and the matter is presently awaiting decision by the Commission.

---

[17] Southern Louisiana Area Rate Proceeding, Docket No. AR61-2, Exh. 119B, Schedule 9; Exh. 114, Part D.

CONCLUSION

Both within the context of the instant Permian Basin case and within the broader context of area rate-making generally, we believe it is urgent that this Court make clear (a) that the Federal Power Commission has authority to fix rates on an area basis, and (b) that in area rate-making, as in the individual-company approach, the touchstone to meeting the statutory just-and-reasonable standard is the cost, both operating and capital, of providing the regulated service. As part of its decision, this Court should affirm the court of appeals' holding that all costs must be determined and costs and revenues balanced, and should reject the Commission's holding that the rates for all gas may be fixed by reference to the costs of only a portion—here, the highest-cost portion—of the gas.

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October 9, 1967.

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THE PERMIAN BASIN AREA RATE CASES

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On Writs of Certiorari to the United States Court of Appeals for the Tenth Circuit

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BRIEF FOR PRODUCER RESPONDENTS SUPPORTING DECISION OF COURT BELOW

PRELIMINARY STATEMENT

It is our position that the decision of the Court of Appeals should be affirmed. Therefore, this brief responds to the briefs filed on behalf of the Federal Power Commission (Commission), People of the State of California, *et al.* (CPUC), Pacific Gas and Electric Company, *et al.* (California Distributors), the City of

Los Angeles, all sometimes referred to herein collectively as "petitioners", and the brief *amicus curiae* of the Associated Gas Distributors Group (AGD).[1]

OPINIONS BELOW

The opinion of the Court of Appeals (XII R. 15-61) and its opinion on rehearing (XII R. 87-89) are reported at 375 F. 2d 6. The opinions and orders of the Commission are reported at 34 FPC 159 (R. 516d-826d), 34 FPC 418 (R. 827d-238d), 34 FPC 424 (R. 37s), 34 FPC 1068 (R. 1105d-1132d), and 34 FPC 1082 (R. 1133d-1136d). The decision of the hearing examiner is reported at 34 FPC 306 (R. 97d-364d).

JURISDICTION

The jurisdictional requisites are adequately set forth by the Federal Power Commission.

STATUTES INVOLVED

The statutory provisions involved are Sections 4, 5, 7, and 19(b) of the Natural Gas Act, 52 Stat. 822, 823, 824, 831 (1938), 56 Stat. 84 (1942), 15 U.S.C. §§ 717c, 717d, 717f, and 717r, and Sections 4 and 8 of the Administrative Procedure Act of 1946, 60 Stat. 239, as recodified, 80 Stat. 378 (1966), 5 U.S.C. §§ 554 and 557. Sections 4, 5, 7 and 19(b) of the Natural Gas Act are reproduced in the Appendix to the Commission brief. Sections 4 and 8 of the Administrative Procedure Act are reproduced in the Appendix to this brief.

---

[1] References to briefs of these parties are by the abbreviations "FPC Br. —," "CPUC Br. —," "PG&E Br. —," and "L.A. Br. —." References to the printed record are by the system set forth at FPC Br., p. 1, fn. 2. Unless otherwise indicated, all emphasis in quotations herein is supplied.

QUESTIONS PRESENTED

The Court of Appeals found that the Commission's group rate orders were not supported by complete findings based on substantial evidence which would permit an application of the end result test of their justness and reasonableness. It remanded the proceedings for a limited purpose—that is, for completion of the administrative findings required to apply the end result test. Although numerous subsidiary issues are raised in briefs seeking to affirm the Commission's administrative decision in its entirety, there are two principal issues raised by the decision of the Court of Appeals:

(1) Whether a reviewing court can determine that the Commission's group rate orders are just and reasonable under the end result test where there are:

(a) No record or findings determining or supporting the actual levels of the group rates prescribed in the rate orders and the revenues generated by such rates; and

(b) No record or findings comparing the regulated group's revenue requirement, as found by the Commission, with revenues under prescribed rates.[2]

(2) Whether the court below correctly concluded that rate reductions and refunds can be ordered only

---

[2] The Commission's goal, as cited by this Court, was "'. . . the determination of fair prices for gas, based on reasonable financial requirements of the industry' for each of the various producing areas of the country." *Wisconsin* v. *Federal Power Commission*, 373 U.S. 294, 299 (1963) ("*Second Phillips*").

when the revenues of the regulated group exceed the revenue requirements of such group.

We also respond to subsidiary issues properly raised in briefs of petitioners.

COUNTERSTATEMENT

The decision of the Court of Appeals entered on January 20, 1967 sets forth the procedural history of this case in detail. By that decision, the Court of Appeals affirmed, almost in its entirety, the administrative decision of the Commission in the Permian Basin area rate case, Opinion No. 468, 34 FPC 159, as modified on rehearing in Opinion No. 468-A, 34 FPC 1068 (R. 516d-826d and R. 1105d-1132d).

The Commission decision prescribed rates for interstate sales of natural gas on a group and area basis for the first time. It also included a limited procedure for affected producers to apply for specific exception from the area rates (R. 551d, 656d-660d). All of the maximum rates prescribed rested solely upon Commission computations of average unit costs of producers in the designated area.[3] However, the Commission also required that the maximum ceiling rates based on these average unit cost determinations be adjusted downward by the unknown costs incurred by pipelines to bring gas up to so-called "quality" standards, as set forth for the first time in the Commission

---

[3] Contrary to repeated implications by counsel for the Commission (*e.g.* FPC Br., p. 17), the Commission stated in its decision (R. 614d):

> "In summary, when all of these factors are considered there is no justification in this area for any adjustment of a cost-determined ceiling price . . .".

decision (R. 645d-654d). Although the Commission made estimates of producers' unit costs, and the bulk of the record relates to these computations, there was no record or finding as to the pipelines' costs to be used for the rate deductions required. As a result of this and other defects, there was and is no basis in the Commission decision to determine either the actual group rates or the group revenues actually generated by such rates.

Upon review, the Court of Appeals sustained the Commission in most substantial respects, including the Commission's use of the area rate method for establishing just and reasonable rates for producers (XII R. 31-38). However, the Court of Appeals found the Commission's decision incomplete and defective as to rates prescribed and remanded for the purpose of permitting additional findings as to aggregate revenues and impact of the rate orders, as required under Sections 4 and 5 of the Natural Gas Act. Thus, the Court of Appeals' reversal and limited remand were directed to the Commission's failure to complete its statutory duty as provided in the Act and by the end result test in this Court's controlling decision in *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944). On rehearing, the court modified its decision to include corollary instructions for the Commission to order refunds only if the regulated group's aggregate revenues exceed its aggregate revenue requirements on an area basis (XII R. 89-91).[4]

These essential holdings of the Court of Appeals have been obscured here by argument upon a plethora

[4] This accords with the decision of the Examiner (R. 274d).

of subsidiary issues and premature contentions. Significantly, the decision below did not reverse Commission Opinion Nos. 468 and 468-A as to:

(1) The constitutional and statutory authority for promulgating area rates;

(2) The geographical area prescribed for the establishment of the area rates;

(3) The "dual-price" system adopted;

(4) The underlying cost data, statistics and other source material on which the Commission predicated its controlling unit cost determinations;

(5) The unit cost determinations made by the Commission which were the sole and only basis for the Commission's area rates;

(6) A two and one-half year absolute moratorium on the right to file for rate increases under Section 4(e) of the Act, above the prescribed ceilings;

(7) Adoption of quality standards for gas sold in the Permian Basin area, if properly supported;

(8) A separate classification providing special treatment for small producers.

Hence, many of the Commission's fundamental findings and conclusions were sustained by the decision below. The Court of Appeals, however, held that the end result test, spelled out by this Court in *Hope,* is applicable to the administrative decision in group rate proceedings—a holding consistent with theories upon which the area rate experiment was initiated, tried, and espoused by the Commission itself in its opinion. The Court of Appeals therefore looked for but

could not find the end result of the Commission's area rate decision, because (1) the Commission had failed to make the required findings which would permit a reviewing court to apply the test, and (2) there are evidentiary deficiencies in the record. The Court of Appeals thus specified two definitive areas where the record and the Commission's findings are lacking.

First, the court below could not determine the impact of the Commission's rate orders on the regulated group because the prescribed rates were subject to unknown, and on the administrative record unknowable, deductions for the so-called quality factors. Contrary to the Commission's claim (FPC Br., p. 22) that it was reversed solely because it did not match group revenues with group costs, the court below was precluded from completing its review and had no basis to determine whether the end result of the Commission's rate orders was "just and reasonable," because it did not and could not know the actual rates ordered by the Commission or their financial impact. We still do not know.[5] As a result, the court below could not evaluate the rate of return allowed because the Commission, again without any findings or record support, included in its rate of return some unknown amount for the alleged risk of finding so-called sub-quality gas. As the court stated (XII R. 60-61):

> "... The Commission did not make those findings and indeed it could not have done so because of the failure of the record to disclose the revenue

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[5] Commission counsel continue to compute impact of the quality deductions from material *de hors* the administrative record (FPC Br., p. 18), but even at this time impact estimates are still incomplete and subject to change.

impact of the adjustments in the area rates to reflect quality differentials. Whether rate reductions because of quality deficiencies are a risk or a cost, the answer comes out the same. If they are a risk, we do not know the rate of return. If they are a cost, we do not know whether the revenue received will equal the reasonable revenue requirements. We believe that under Hope, and under Second Phillips, the area producers, as a group, are entitled to recover their prudent operating expenses and capital costs with a return commensurate to the risk and sufficient to attract capital. Satisfaction of this requirement must appear through appropriate findings based on substantial evidence. These cannot be made on the record presented."

Second, the Court of Appeals held that, despite expressions of theory, the Commission abandoned in practice and in fact the end result test in favor of general statements as to an undefined and unspecified "fair relationship" between its unit cost determinations and the ceiling rates prescribed in its orders. The court below thus held (XII R. 60):

". . . The Commission held that its ceiling prices provided a 'fair relationship' between consumer prices and producer costs. Fair relationship is pertinent but it is only part of the end result test. We do not know the producers' costs or revenue requirements. We do not know the economic factors which either require or permit departure from costs and revenues. The end result test is not satisfied by a reliance on unknowns.

"We have accepted the Commission's conclusion that contract rates should not be used. The trouble is that the Commission decision rides two horses and we have no way of knowing the out-

> come of the race. It uses composite cost-of-service evidence, engrafts economic factors on top, and comes out with a rate which it justified on a fair relationship basis. We have the problem of how in such circumstances a court can determine whether the just and reasonable standard of §§ 4 and 5 has been met. The answer is not found in the record before us."

Hence, the court remanded the case to enable the Commission to complete its task (XII R. 61):

> ". . . The Commission will hold such additional hearings as are needed to determine the effect of the quality adjustments, and to determine the group revenues and the group revenue requirements. It will make appropriate findings on these matters . . ."

This limited remand neither condemns the area rate method adopted by the Commission nor disturbs most of the underlying determinations made by the agency. In effect, the Court of Appeals merely requires the Commission to design rates consistent with its other findings, to supplement the administrative record as may be required for this purpose, to receive evidence supporting its decision on quality deductions, and to complete its own statutory functions as defined in *Hope*.

SUMMARY OF ARGUMENT

The Commission's prescribed rates in this case are unknown. As held below, the Commission must make necessary additional findings as to the revenues derivable from rates to be placed in effect under the area rate order. If lawful standards are then applied and rates consistent therewith are prescribed, area rates

will generate the revenues required and will be valid. Therefore, we urge that the decision below be affirmed.

I. Area rates can be valid if they permit opportunity to recover the aggregate revenue requirement and are consistent with *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944).

A. The Commission made no determination of the revenues which would be generated by its area rates; nor would the record evidence permit such determination. Under the Commission decision, rates to be placed in effect are dependent upon certain pipeline costs not in the record; the resultant producer rates are unknown; revenues to be derived are unknown; and it is not possible to ascertain what costs could be recovered or what return has been allowed. These gaps cannot now be filled by counsel or by references to materials outside the record. The court below thus pinpointed deficiencies and required only that the Commission apply the Act's standard and the end result test.

B. Rates do not become "reasonable" by the mere assertion that they are "fair", or simply because some parties avow that cost computations are "generous." Commission computations in this case are based upon findings of the costs of gas-well gas. These costs do not include costs attributable to oil or other commodities. The Commission stated that its "yardsticks" of gas costs were to be the basis for testing and prescribing all rates in this case. The record showed that average area revenues for the test year and subsequent years were below these "yardstick" costs. Nevertheless, the Commission ignored the existing rate structure, disregarded its own cost findings, and ordered into effect a system of rates under which (1) maxi-

mum ceiling rates would be fixed at the level of average costs; (2) certain pipeline costs not in the record would be used for subtractions from these ceiling rates to arrive at lower rates applicable to most of the gas in this area; and (3) the rates prescribed would become effective without findings as to the impact of the deductions and without comparison with the Commission's cost findings. Thus, the actual end result became an unknown, and the total effect is not measurable against any standard. Even *de novo* cost computations by this Court could not test the rates prescribed, because they depend upon data as to pipeline costs not in the record.

C. The Commission's use of producers' average unit costs as maximum ceiling rates bars recovery of revenue requirements. Because of differences in gas quality and delivery conditions, the Commission prescribed a range of rates, rather than a single rate. However, any system of rates must allow opportunity for recovery of the aggregate revenue requirements. But that opportunity is precluded if average cost is used as the maximum ceiling, and rates are reduced by deductions for quality differentials. If an average unit cost is used as the focal point of rate design, the Commission must adjust prescribed maximum and minimum rates so that the body of rates permits opportunity to recover the overall, aggregate revenue requirements.

D. Another bar to opportunity for recovery of the aggregate revenue requirements is the fact that contract prices above the maximum ceiling are reduced to that ceiling, but the many contract prices below the average-cost based ceiling cannot be increased. The Commission erroneously refused to consider the resulting revenue deficiencies in its rate design. How-

ever, low contract prices have been and will be a fact of life in this industry, and the Commission must recognize this fact and the resulting inevitable revenue deficiencies in design of maximum and minimum rates. *New England Divisions Case,* 261 U.S. 184 (1923); *King* v. *United States,* 344 U.S. 254 (1952). The court below exposed the error of the Commission and required it to consider such circumstances on remand, leaving to the Commission the precise method of adjusting rates to correct the error.

Adjustment for such revenue deficiencies resulting from low contract prices does not require the Commission to violate the principles of *Federal Power Commission* v. *Sierra Pacific Power Co.,* 350 U.S. 348 (1956). The Commission and its supporting petitioners erroneously assume that the sole remedy authorized by the court below is the prescription of higher minimum prices, which they assert constitutes the abrogation of contracts, contrary to *Sierra.* The court's remand does no violence to *Sierra* and is not so confined. A remedy expressly authorized by the lower court is the establishment of ceiling prices at levels higher than mere average costs so as to permit revenues from contracts with prices above average costs to offset revenues from lower priced contracts. For it is the totality of the revenues flowing from the prescribed rates which is controlling. In *Second Phillips,* both the Commission and this Court recognized that individual contract prices are not excessive merely because such prices exceed an average of costs. Adjustment for lower priced contracts in rate design may therefore be accomplished by an increase in the maximum rate, an increase in the minimum, or a combination of both, in a manner wholly consistent with *Sierra.*

E. The attempt of Commission counsel (FPC Br., p. 96) to show that test year average revenues are in approximate balance with industry revenue requirements, by use of materials outside the record, is misleading and wholly without evidentiary support. The Commission specifically found that the "yardstick" average cost of flowing gas in the test year was 14.5¢ per Mcf. This must be compared to test year average revenues of 12.72¢ per Mcf. Counsel's improper subtraction of their 1.5¢ per Mcf average quality deduction from the cost side of the equation, rather than from the revenue side, cannot conceal the serious imbalance between industry revenues and revenue requirements under the Commission's prescribed rates. The Commission's opinion requires a deduction from the revenue side through a reduction in rate, but Commission counsel's equation is achieved through an improper deduction from the cost side. This attempted equation, of itself, demonstrates why further Commission findings must be made on remand.

F. Shift to group procedures cannot eliminate necessity for findings as to revenue requirements and necessity for prescription of rates consistent with the Act and end result test. Under regulation, the producers' opportunity to recover their costs, including return, is controlled by the rates actually prescribed. This remains true under the area method. Rates still must generate revenues to cover required expenditures in exploration, development, and production, and a return allowance consistent with the Act's standard. As under other statutes, the purpose of this group procedure must be a Commission determination of aggregate revenue requirements on a group and area basis. Unless this determination is actually used as a control

in the succeeding steps of rate design, rates and revenues cannot be connected to findings of revenue requirements, and no lawful standard can be applied in the *prescription* of area rates.

II. The rate-of-return remand by the court below was inescapable.

The Commission adopted as reasonable a 12-percent rate of return. From the rates it fixed, the Commission provided for downward adjustments for gas of less than pipeline quality, which includes most of the gas in the Permian Basin. Because of the absence of evidence of the impact of these quality deductions and because they were treated as an item of risk rather than an item of cost, the court below concluded that there is no basis on which to appraise the Commission's return allowance.

The imposition of the quality-deduction penalties makes it impossible for producers to earn the purported 12-percent return allowance. This is unaffected whatever the later facts might show as to the impact of those deductions, since the rate of return actually allowed was 12-percent minus "x."

The sole defense now advanced by Commission counsel is their claim that the Commission's 12-percent allowance was intended to be applied restrictively to gas of pipeline quality. But that claim is refuted by an analysis of what the Commission actually did. The claim that 12-percent is only for pipeline quality gas is incongruous when paralleled with the holding by the Commission that it should, and did, in arriving at the 12-percent rate, take into account the risk of finding gas below pipeline quality. More importantly, the Commission's opinion shows beyond dispute that

the 12-percent return was developed in relation to production activities generally, not to gas of pipeline quality. Indeed, no separate rate base was developed for gas of pipeline quality, and there was thus no separate base against which the prescribed rate could be multiplied to produce a return allowance for gas of pipeline quality only, as Commission counsel now claim.

The foregoing considerations likewise make it impossible for producers to recover their costs in the aggregate. The producers' costs determined by the Commission were intended to represent the general experience in finding and producing the entire mixture of Permian gas, not just gas of pipeline quality. Its rates were fixed solely on the basis of such costs. But these rates would be denied to all but a fraction of Permian gas, through imposition of the quality-deduction penalties. For these reasons, the rate-of-return remand by the court below was unavoidable and required by due process.

III. The Court of Appeals correctly concluded that in an area rate proceeding the end result test and this Court's holding in *Second Phillips* sanction the imposition of refunds as to locked-in increases *only* to the extent that the regulated group's revenues exceed the group's revenue requirements.

A. Absent a supportable finding of undue discrimination or undue preference—and none was made or could properly have been made here—this conclusion assures that consumers will not bear, or producers receive, excessive prices for gas. Consumers are charged only the pipelines' "rolled-in" or aggregate purchased gas costs, which on a unit basis is the average price per Mcf paid by pipelines. Hence, authorizing refunds to the extent only that the area producers'

aggregate revenues exceed their aggregate revenue requirements during the locked-in period, as the court below held, fully protects the interests of consumers and producers. For it effectively precludes producers from receiving and consumers from paying excessive gas prices.

The holding by the court below is not, as urged by petitioners, contrary to this Court's holding in *Federal Power Commission* v. *Tennessee Gas Transmission Co.*, 371 U.S. 145 (1962). That case, which was decided at the same term but several months prior to *Second Phillips*, authorized the Commission to require interim refunds when total revenues were found to be excessive, even though future rate orders *might* result in revenue deficiencies in a specific rate zone. In our case, there was and could be no finding that total revenues were excessive; nor was there any finding that any individual rates were unduly discriminatory or preferential. Application of *Tennessee* here would require the assumption that individual rates above average costs are *per se* unlawful. *Second Phillips*, which is controlling here, expressly rejects such assumption.

B. No issue as to refunds below the last firm rate was decided by the Commission. The Commission's power to require such refunds, asserted by California, is therefore not an issue before the Court.

IV. Underlying Commission cost allocation methods need not be reviewed, but in any event, the Commission's ultimate findings cannot be deemed "generous."

A. The lower court did not reverse the findings of the Commission with respect to the underlying technical and complex joint cost allocation issues. It found that these matters were primarily for agency expertise

and need not be the subject of detailed judicial review in this case. It thus would be improper to approve the allocation methods used in this case as precedents to be mechanically applied in subsequent area cases, when flexibility is clearly required by the agency. The Commission's opinion recognizes that in this first area proceeding it has not been possible to resolve finally all of the technical and complex issues with respect to costing formulae and data sources. The door must be left open in future proceedings for consideration of new or improved data, refinements in the costing techniques, changed circumstances and differences among geographic areas.

B. In any event, there is no record basis for the contention of the California petitioners that the Commission's "cost" determinations include an "extra" element of "generosity" justifying a design of rates which mathematically forecloses the producing industry from recovering the Commission-determined costs. California's arguments reflect a lack of understanding of the Commission's costing methods, particularly with respect to the derivation of the exploration cost component. The Commission's revenue requirement is based upon a "barebones" cost determination for natural gas *only*. In almost every instance, the Commission selected the cost allocation method which would produce the lowest cost for gas.

V. The Commission failed to provide adequate notice to the parties that its rate order would provide for an elaborate system of quality standards which would form the basis for substantial deduction from maximum ceiling rates. As a result, no evidence was presented to support the establishment of such standards as a feature of the rate design in the Permian Basin

area. The Examiner found it would be impossible on this record to establish such standards. The arbitrary standards adopted by the Commission result in about 90% of the gas volumes being subject to downward price adjustments. This additional barrier to the recovery of industry revenue requirements cannot be supported by the record evidence in this case.

A patent error also exists in the Commission's 50 Btu gap between its minimum standard of 1000 Btu per cubic foot for downward adjustments and its allowance of upward price adjustments for only gas above 1050 Btu. The lower court found such Btu gap had not been justified. It is uncontroverted that the pipeline standard for the area is 1000 Btu. The Commission looked to the area pipeline contracting practices in establishing its minimum standards for all quality factors *other* than Btu. This inconsistent treatment is unjustified, particularly where the high minimum standards adopted by the Commission with respect to other quality factors, such as pressure, sulphur content, and water, result only in *downward* adjustments from the maximum rates. If the Commission had permitted upward adjustments for Btu above 1000, this would have been consistent with the method used to fix the other standards.

VI. The "savings clause" is inadequate, as held below. The Commission is told only that, as it does in other rate procedures, it should articulate with clarity the guidelines for petitions for special relief and, where those guidelines are followed, should grant stay of application of the general order to the petitioner. Such provisions in group procedures insure statutory and constitutional protection in rate regulation. Legality of the area rate method and legality

of group procedures under the Natural Gas Act depend upon inclusion of such adequate "savings clause" procedures.

VII. The California petitioners, in addition to seeking affirmance of the Commission's concurrent certificate order, also ask the Court to hold as a matter of law that the area rate should be mechanically adopted, without further inquiry, as the initial certificate price in *future* Section 7 proceedings. This issue was not before, or decided by, either the Commission or the lower court in this case and is not properly before this Court. The many complex issues which would result from any such prejudgment of the present or future public convenience and necessity, as urged by the California petitioners, are raised in No. 373, this Term, a separate case involving a Section 7 certificate order in which later hearings were convened *subsequent* to the establishment of the Commission's area rate.

VIII. The lower court committed no error in imposing a 4.5 percent interest obligation in its stay order. The Commission denied stay, and when stay was granted by the Court of Appeals there was then no Commission order applicable to funds collected on or after September 1, 1965. In granting stay, the court therefore was not passing on the merits of any provision of a Commission order, but exercising separate judicial powers under Sections 19(b) and (c) of the Natural Gas Act. Those powers include prescription of conditions of stay based on the court's assessment of the equities. The court's interest provision—identical to that used by the Commission itself as to other separate funds being retained subject to further Commission order—applies to funds collected pursuant to court order only. As in numerous other cases under

the Act, the Court of Appeals' authority thus included prescribing the interest provision in its own stay order.

IX. The Commission's assurances that its prescribed rates will elicit adequate supplies of natural gas are unsupportable. The Commission did not and could not find the supply-inducing effect of its prescribed rates because it did not and does not know the revenues which would flow therefrom. The effect of its prescribed rates, less deductions for quality deficiencies, was to reduce revenues below average costs. This will exacerbate the declining trend in reserves relative to demand and in gas exploration. Neither pipeline prepayments nor recent drilling activities in the Permian Basin, referred to in briefs supporting the Commission, belie these trends. Nor do they offer any reliable indicia that the Commission's prescribed rates could result in the level of gas inventory required.

X. Remand for Commission correction of the defects in rate design is essential. The solution is not, as Commission counsel argue, to permit wholesale waivers and exemptions from the general order. The solution must be a workable general order resting upon Commission findings of aggregate revenue requirements and upon prescription of rates permitting the opportunity to recover those requirements. The time required to correct the order in this pilot case is not inordinate, and the mechanics involved are simple. All affected interests will be served if the area rate method of regulation is initiated under standards lawfully applied, sufficiently understandable for use in pending and subsequent cases, and tied by administrative findings to rates permitting recovery of revenue requirements.

ARGUMENT

INTRODUCTORY STATEMENT OF POSITION

Our position is that the area rate method can be lawful if the Commission (1) prescribes rates affording to the regulated group an opportunity, in fact, to recover the aggregate revenue requirement shown by the record evidence in the area rate proceeding; and (2) preserves procedures according due process to all parties, including opportunity to demonstrate need for exceptions from a rate so prescribed on the basis of group cost data.

Valid area rate orders require answers, based on findings upon record evidence, to the following questions:

(1) What are the revenue requirements of the regulated group?

(2) Are revenues at existing rates above or below these requirements?

(3) Are any existing rates unduly discriminatory or preferential?

(4) If existing rates are to be set aside, will the rates prescribed in lieu thereof permit opportunity to recover revenue requirements?

The court below correctly concluded that the Commission's findings in this case leave these questions unanswered, and only the Commission can correct the defects. If the area method is administered in accordance with the principles so stated by the Court of Appeals, products of area rate cases can be consistent with standards of the Act and demonstrable requirements of this regulated industry. This does not mean

that perfection would be achieved in this case, or that all arguments rejected by the Commission and the court below upon this record are unsound for all cases and time.[6]

We, however, have not pressed arguments rejected below because remand will afford the Commission opportunity to correct, with promptness, patent defects in its decision in this case. To that end, this brief responds to those who still seek total affirmance of the Commission's orders. We also show that correction of this pilot product entails but minimal time and is essential to lawful application of the area rate method in this and other areas. Those who seek total agency affirmance nevertheless strive to create an aura of urgency, demanding acceptance of all Commission pronouncements, regardless of defects or effects, as precedent for all areas. They refer to Commission delay in evolution of producer regulation and argue that steps now required for correction of errors are but further hardship.

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[6] The Commission's brief all but ignores the questions raised in its own petition to this Court and instead is devoted largely to other questions, apparently anticipating the briefs of other petitioners. We do not respond to these arguments extraneous to the Commission's own petition, but it must be understood that we do not thereby agree with the Commission's arguments or assertions on these numerous issues. For example, the Commission would have this Court believe that all producers urged that the primary—if not exclusive—guide for rate review simply should be existing contract prices. This is erroneous and misleading. In fact, we contended below that the Commission must look to all significant economic indicators of costs, price and supply—not that it should simply validate all existing prices. Contract prices are useful evidence, but not the only measure, of proper prices.

But here, as in the only other producer rate case to reach this Court, the record "does not paint a picture of the public interest sacrificed on the altar of private profit." *Wisconsin* v. *Federal Power Commission,* 373 U.S. 294, 312 (1963). Average industry revenues in the Permian Basin area for the test year 1960 were only 12.72 cents per Mcf (R. 538e). This contrasts with the Commission-determined average revenue requirement for "flowing" gas of 14.5 cents per Mcf. Moreover, sales initiated since August 5, 1965, have been at rates "conditioned" to area rates under review.[7] Thus, there is no possibility of price escalation during the limited period required to correct this order. The alternative would be acceptance of ill-defined standards generating confusion in other pending cases.[8] The result here would be a pricing system requiring inevitable wholesale exceptions and early initiation of a second area rate case for this area.

Haste for the sake of haste cannot eliminate the requirement for the administrative findings which the Act and this Court's decisions demand. Affirmance of this incomplete order could but serve as precedent for ill-fated attempted shortcuts in rate proceedings and substitution of subjective expressions, such as

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[7] The Commission automatically applies these "area rates" in issuing both temporary and permanent certificates under Section 7. See *Phillips Petroleum Co.* v. *Federal Power Commission,* 377 F.2d 278 (10th Cir. 1967) (petitions pending, Nos. 373, 380, and 385).

[8] See, *e.g.,* the "Motion for Leave To File Brief Amicus Curiae and Brief Amicus Curiae on Behalf of the Associated Gas Distributors Group" which in effect asks the Court, if it leaves the instant orders standing, to make clear that the standards and rate design principles at issue need not be applied in other pending cases.

"fairness," for the clarity and record-supported findings now required under this Court's holdings applicable to federal rate regulation. This would produce a multiplicity of appeals to this Court for *de novo* review of agency action. The requirement that the Commission complete its statutory functions will involve a limited time, but completion of this case in accordance with applicable standards is required to establish a lasting framework for future group rate regulatory action under this and other statutes.

For these reasons and those shown *infra,* we urge the Court to require agency correction of the defective design of rates in this case. Demands of the Far West for natural gas, dependence of that area upon this fuel and energy source, and the vast investments required of the producing industry to meet that demand and dependence, preclude a trial-and-error approach. As the Commission found (R. 568d):

> "This Commission cannot discharge its responsibilities to the public by relying on unsupported suggestions that gas supplies from distant sources or other forms of energy will suffice to meet an obvious need for new gas supplies to serve the needs of the pipelines and of their consumers who are tied to the use of this fuel by large investments in gas utilization equipment."

The Commission likewise cannot discharge its responsibilities until it resolves the unanswered questions as to producers' required revenues and prescribes rates consistent with those requirements.

I. VALID AREA RATES MUST BE CONSISTENT WITH THE END RESULT TEST AND PERMIT OPPORTUNITY TO RECOVER REQUIRED REVENUES.

A. The Standard Applied by the Court of Appeals Emphasizes the Agency Function and Permits Commission Correction of Patent Errors.

Essential to validity of any method of rate regulation is a definable, understandable standard for testing rates at the regulatory level and in any subsequent review. The court below recognized that such an objective standard must be expressed with clarity and applied with consistency *throughout* the process of testing *and* prescribing rates. Tests set out by the court below thus apply this Court's construction of the Natural Gas Act and require only the most elemental findings in rate regulation—answers to the basic questions of what are the revenues required, what is the return to be allowed, and will those requirements and allowances be recovered through the rates fixed.

The inconsistent efforts to defend the Commission opinion seek to obscure errors laid bare by the court below. To the threshold question of what are the substantive requirements for a valid area rate, the court but emphasizes the Commission's failure to complete its own tasks. The agency product to date consists of: (1) an elaborate defense of authority to use group procedures as such; (2) a detailed series of conclusions as to average unit costs of the group, including required return, in which the Commission, as did parties before it, recognized that standards of *Hope* apply; and (3) prescription of a system of rates unconnected to cost and return findings, dependent upon pipeline costs not

in the record, being unknown at the time of decision and generating an unknown amount of revenues.

In defense, Commission counsel argued below that this "result" is "fair"; that cost and return computations do not necessarily represent findings of revenue requirements; that even though prescribed rates are unknown, the Commission has information, not in the record or available to the parties or the courts, indicating what the deducted costs are and what resultant "adjusted" rates will be; and that the return will be considerably lower than that set out in the opinion, but probably and approximately what the Commission intended to allow.[9]

Confronted with these omissions and inconsistencies, the Court of Appeals held:

(1) Under the Act and the Commission's own expressed objectives, the end result of area rate orders must be rates that do not preclude opportunity to recover costs, including a return commensurate with the risk of capital;

(2) Under these standards, the Commission must find the revenue requirements and prescribe rates consistent with its findings upon record evidence;

(3) If it finds that existing contract limitations depress revenues, adjustment must be made for this effect in fixing maximum and minimum rates; and

(4) The Commission, not a reviewing court, must fill these gaps, make the additional findings required, and initially apply the Act's standards.

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[9] Brief for the Federal Power Commission before the Court of Appeals, pp. 39-41, 118-127, 66, 70-73.

The court below thus pinpointed patently reversible errors.[10] For the reasons that this Court established the *Hope* test—to free parties, agencies, and the courts from vagueness and complexities of the "fair value" rule—the Court of Appeals was compelled to remand this case. The Commission is allowed latitude in making cost findings, considering economic factors, assessing incentives required, measuring risk, and determining allowances needed to meet growth in market demand. The Commission is told only that once it has made these findings, *totalling* up to an ultimate finding of revenue requirements, rates prescribed must permit opportunity to recover those requirements. The Commission is admonished to use, not discard, its record when it reaches this step of prescribing rates. If it then decides that resort must be to still other data, those data should be part of the record. The result must be rates known and testable. Upon review, the parties should not be confronted with unknowns, and the courts should not be asked to bless unknowns. The court below but correctly requires that the agency task be properly completed.

B. An Expression of "Fairness" and Judicial Testing of Subjective Allegations of "Generosity" Cannot Be Substituted for the Act's Standard.

In contrast to clarity required by the decision below, the Commission and its supporting petitioners would discard the standards of the Act and carve an exception to statutory and constitutional requirements in rate regulation.

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[10] *National Labor Relations Board* v. *Metropolitan Life Insurance Co.*, 380 U.S. 438 (1965); *Burlington Truck Lines, Inc.* v. *United States*, 371 U.S. 156, 157 (1962); *Colorado and Wyoming Gas Co.* v. *Federal Power Commission*, 324 U.S. 623, 633-635 (1945).

These parties urge that, where group procedures are used, an agency statement of "fairness" should suffice, rates unknown at the time of decision should be permitted, and reviewing courts would assess "fairness," if at all, only by (1) weighing subjective notions as to whether scores of underlying cost computations are "generous" or not, and (2) accepting arguments from materials considered by the agency long after decision; computations made and remade during the steps of review in the Court of Appeals and this Court,[11] and figures said to indicate that results are not quite as unknown as they appeared to be at the time of decision (R. 1115d).

Aside from procedural irregularities, such an approach would return federal rate regulation to the chaotic state pre-dating *Hope*. The major error laid bare below is not in *how* costs were computed, but in whether those costs can be recovered through rates prescribed. The difficulty thus lies not so much with what the Commission said, but with what it in fact *did*. Yet, as to standards actually applied, the Commission's position remains equivocal. Its brief, as its opinion, seems to recognize that the product of area rate cases must comport with *Hope*, and objectives are still phrased in terms used in *Hope*.[12] Nevertheless, the

[11] *E.g.*, the erroneous computations appearing at FPC Br., p. 96.

[12] *E.g.*, in its opinion, the Commission stated that the product of the area method should be ". . . a just and reasonable rate fixed on the basis of the overall costs and profits of the producers in the area . . ." (R. 549d). Here, the Commission states that ". . . an area rate based on area costs is economically realistic" (FPC Br., p. 56), and in discussing its "new gas" rates, the Commission correctly states: "Producers will not utilize their new-found ability to search for gas reservoirs unless the area rate is high enough to cover their current costs of finding and producing gas-well gas." (FPC Br., p. 86)

Commission confesses that, at the time of decision, it did not know what pipeline costs would be used as subtractions to arrive at "applicable area rates," or what producer costs, including return, could be recovered by those rates. (R. 614d)

The computations of producer costs—the *only* "yardstick" employed—are defended to the last decimal, but the errors of rate design, according to the Commission, do not require correction. They may be ignored, as we understand the argument, because a hypothetical return not allowed in prescribed rates is claimed to be "higher" than customary; the revenue deficiency caused by subtracting pipeline costs is not as great as anticipated; and deficiencies flowing from low contract prices are not of Commission concern. We discuss each of these arguments *infra,* but at the outset, analogy between the Commission argument and vagueness of the "fair value" concept condemned in *Hope* is obvious.[18] The Commission seems to be saying that because it referred to *Hope* in computing costs and return, connective steps to translate theory into rate design are not required. But, under *Hope,* it is not "theory" but "impact" which is the touchstone of a valid rate.

As to standards, CPUC, *et al.,* California Distributors, and Los Angeles are more candid. They state

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[18] The Commission argument thus echoes back to Justice Brandeis' criticism of the discarded "fair value" rule: "The result, inherent in the rule itself, is arbitrary action on the part of the rate-regulating body. For the rule not only fails to furnish any applicable standard of judgment, but directs consideration of so many elements that almost any result may be justified." *Missouri ex rel. Southwestern Bell Tel. Co.* v. *Public Service Commission of Missouri,* 262 U.S. 276, 296-298 (1923).

that in group proceedings an agency expression of "fairness" is all that should be required; that the Commission need not make findings as to group revenue requirements or the degree to which rates prescribed will permit recovery of the aggregate revenue requirement; that the "yardsticks" are "generous" and differ from "actual costs"; and that after a court reviews each such item piecemeal, it should leave the order undisturbed.

Under their approach, *Hope* would be discarded and *de novo* and *seriatim* review of underlying cost computations would be required. Review, once an agency affixed the label "fair," would be, according to CPUC, the intricacies of " . . . a more careful look at the Commission's decision to see if it strikes a fair relationship between these [the group's] cost and revenues."[14] But this argument is advanced without regard for what the Commission actually did in this case. The "total effect," discussed by CPUC, *et al.*, is unknown if rates are unknown at the time of decision, and careful scrutiny of the steps used by the Commission shows that the arguments of California Distributors and CPUC, *et al.*, have no foundation in this record.

The Commission selected the area, defined the group, chose the 1960 year for testing rates, and has been sustained as to these choices. So beginning, the record told the Commission that, under all rates in effect in 1960, aggregate jurisdictional revenues averaged *only* 12.72 cents per Mcf (R. 538e). The record also showed that these revenues were derived from a range of prices, including low prices dictated by the pipeline

[14] CPUC Br., p. 30.

which had a monopsony position in interstate purchases for more than thirty years, other prices limited by costs of treating to bring raw gas to requirements of this purchaser,[15] and other higher prices negotiated in the postwar period. The issues then before the Commission, as in any rate case, were whether total revenues from this body of rates were excessive or deficient, and whether the range of rates was discriminatory. The Commission omitted findings on these issues, but proceeded instead to the question of how it should prescribe new rates.

From this point, the decisional process was not, as now described, a series of "value" judgments. The Commission rejected the "value" approach to testing rates (R. 558d), and unambiguously stated how the group revenue requirement was to be determined (R. 574d):

> "We shall discuss later in this opinion the cost basis for all other gas but it may be helpful here to say that we shall use the cost of gas-well gas as the yardstick for all prices we fix in this proceeding . . ."

As to construction of this "yardstick," the Commission stated with equal clarity (R. 614d-615d):

> "In summary, when all of these factors are considered there is no justification in this area for any adjustment of a cost-determined ceiling price. We state again that the ceiling price we are here estab-

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[15] See FPC Br., pp. 6-7. As to these prices, the Commission said: ". . . it is obvious that the extremely low prices prevalent during the earlier period of large oil-associated supply and small demand bear no relationship to the cost of exploring for and producing gas even in that period, to say nothing of the present" (R. 555d).

> lishing is for the Permian Basin and that it is entirely possible that in other areas non-cost considerations may require adjustment of the cost figures in establishing the ceiling prices. We hold only that no such adjustments are required on the basis of this record."

The "yardstick" thus is cost, nothing more.

From these conclusions, the Commission derived the figures of 16.5 cents per Mcf for "current cost" and 14.5 cents for "historical cost." Both figures are but products of dividing volumes, unsifted as to "quality," into cost totals, but from these totals the costs actually incurred by producers to bring gas up to "pipeline quality" are *excluded*. Nevertheless, these were the unit cost figures with which the Commission proceeded to rate design, and at this point, proper procedure required the Commission to compare revenues at existing rates against the revenue requirement that it found. If at this point, the Commission found those revenues excessive, or the existing rate structure discriminatory, the Commission then should have proceeded to fashion maximum, average, and minimum rates which would permit opportunity to recover the revenue requirement found to exist.

However, the Commission did not so proceed, and the decisional process fell into the errors that now compel remand. First, the average unit cost figures derived from averaging dollars and unsifted volumes were pegged as the maximum ceiling rates for "premium"—not "average"—quality gas (R. 688d-690d). Second, instead of relying on record data, the Commission interjected a wholly novel source of costs for subtractions to arrive at rates for below "premium" quality gas—pipeline costs not in the record (R.

654d, 690d).[16] Third, this system was ordered into effect without findings as to what these pipeline costs are, what the resultant rates are, and what revenues would be derived therefrom. The end result was thus unknown, and the Commission correctly stated (R. 614d):

> "The record is deficient as to the overall financial impact of these adjustments . . ."

When these errors were exposed, the Commission resorted to numerous materials *dehors* the record in attempts to excuse failure to complete rate design. Thus, in denying rehearing, the Commission referred to figures stated by one of the Commissioners who had dissented in part (R. 1115d) and figures listed in a pleading submitted by one of the parties *after* the decision was entered (R. 1114d). Before the Court of Appeals, still another series of numbers was recited, based on materials received *after* petitions for review were filed.[17] Here, still another series of internally conflicting numbers is unveiled, this time said to be derived from an order issued more than three months

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[16] The Commission concedes here, as it must, that ". . . the pipeline's processing costs were not in the record . . ." (FPC Br., p. 142, fn. 15). It attempts to repair the defect by arguing that *producers'* costs were reflected, and witnesses expressed opinions as to such costs of *producers*. The attempt, however, fails because there is nothing to establish whether the estimates of *pipelines'* costs are more, or less, or equal to indicia of composite costs of *producers*, whose operations obviously are functionally different.

[17] *E.g.*, the Commission's brief before the Court of Appeals referred to materials received by the Commission between its decision on August 5, 1965, and April 22, 1966, and then stated that the reductions of "base rates" for "old gas-well gas" was "approximately 1.1 cents Mcf using 1960 volumes." (Brief for the Commission before the Court of Appeals, p. 76, fn. 50)

after argument before the Court of Appeals, and as to which the Commission issued an "errata" notice on June 9, 1967, while petitions for writs were pending in this Court.[18]

These frantic efforts hardly correct the errors. Even if the current numbers submitted by brief were final (which they still disavow) and accurate (which cannot be determined on the record or by *de novo* findings here), these numbers would merely demonstrate that underlying data and such numbers should have been made part of the record, tested, and considered by the Commission before final orders were entered. The effort also proves that the Commission's elaborate cost and return findings directed toward finding the revenue requirement had no connection to rates prescribed, and that to this day, those who defend these orders cannot say *what* costs may be recovered and *what* return could be earned.

Even if the mere expression of "fair" were translatable into realities of economics and finance, the term hardly applies here. Whether one party or another believes cost computations are "generous" remains beside the point, because rates prescribed are *not* based on *these* computations. The expression of "fair" and the CPUC, *et al.*, procedure requiring *de novo* judicial computations could not be a substantive testing of validity, because even the judicial tally could not answer the question as to what is the end result under

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[18] See FPC Br., p. 18, fn. 15. But compare the statement that ". . . average revenue is expected to be one to two cents less because of quality adjustment and the existence of contract prices lower than the area rate . . ." appearing at FPC Br., p. 90. However, still other computations are advanced at FPC Br., p. 96 which we discuss in detail *infra*, pp. 47-50.

the rates actually prescribed. Yet, it is *that* result which establishes the "impact" and "total effect" and must be known before any adjective such as "fair" or "generous" could have meaning. Since there is no end result here that can be so examined, even the tests suggested by CPUC, *et al.*, require further agency findings in this case.

C. Use of Average Unit Cost as a Maximum Ceiling Rate Absolutely Precludes Recovery of Required Revenues.

Beyond failure to apply an objective standard, the total effect *is* to make it impossible for producers to generate sufficient revenues to recover total revenue requirements. By fixing an average unit cost as the ceiling for premium or "pipeline" quality gas, despite the fact that producers cannot charge this price for most of the gas in this area, the Commission insures that group revenues will never approach revenue requirements.

Notwithstanding the elaborate defenses in the Commission's brief, the undeniable effect of Opinion No. 468 is to reduce all contract prices in excess of average unit cost levels to those levels. At the same time, prices below the average unit cost levels cannot be increased to those levels. The necessity for Commission correction of this error cannot be minimized. It is an arithmetical certainty that the producers as a group cannot recover their revenue requirements if maximum ceiling prices are pegged to average unit costs.

Despite figures from sources outside the record now set out in briefs here, revenue deficiencies under the Commission system are established on the record *even though the degree of error remains unknown.* Commissioner O'Connor estimated a range of the down-

ward rate adjustments to be 3 to 5¢ per Mcf with an average of 1 to 1.7¢ per Mcf (R. 746d). The Commission itself found that the "greater percentage of the gas in the Permian Basin" would not be eligible for the maximum rates pegged to average costs (R. 602d). The record also shows that if rates were reduced *only* to average industry cost levels, approximately 67% of the companies affected could not recover costs, and approximately 30% of volumes would be delivered below costs (Ex. 174, R. 493e, 501e; R. 443e, 446e). Imposing further reductions derived from pipeline costs compounds these deficiencies, but neither Commission findings nor the record permits quantifying the degree of the deficiency.

In design of rates applicable to producers as a group, the *first* controlling consideration must be the *total* amount paid by purchasers, *not* the rate paid under any specific rate schedule. In the absence of any showing of discrimination, purchasers must provide total revenues equal to total revenue requirements or otherwise the total effect to follow can be but liquidation of exploration and production—upon which *all* segments of this industry depend for the commodity transported and sold. Therefore, if imposition of a given price ceiling makes it impossible for producers as a group to recover aggregate costs, it necessarily follows that rates must be redesigned to provide at least the *opportunity* for recovery of those costs. The totality of group rates cannot be unjust or unreasonable if those rates do not generate total revenues in excess of total revenue requirements.

Unquestionably, this is a rate design problem for Commission solution in the first instance. Once it determines the producers' revenue requirements, it is

the Commission's function to design rates which will permit opportunity to generate revenues equal to such requirements. Failure to do so violates the requirements of the *Hope* test.

We do not contend that all contract limitations must be removed by regulatory action or that all rates must be equal to the average unit cost. The Court of Appeals did not so hold, contrary to the arguments now made here by certain petitioners. The court pointed out "the controlling question is whether proper revenue requirements for the producers as a group can be satisfied with rates having the ceiling and floor which the Commission has fixed." (XII R. 57). In other words, the latitude available to the Commission permits a range of rates which enable producers *opportunity* to cover their revenue requirements. Accordingly, if some prices must remain limited to levels *below* an average unit cost, a maximum "premium quality" rate *above* a focal average unit cost is necessary to provide opportunity for recoupment of revenue requirements. Yet, a basic Commission error results from its failure to consider this rate design problem and proceed to a solution. The Commission thus left its task incomplete after it determined average unit cost. Upon remand, the Commission is directed to design rates which, taking into account deductions for quality, could provide the producers as a group, the opportunity to recover their revenue requirements.

It is argued here that the gap between the average unit cost and the revenues which will actually be collected may be ignored because the average unit "cost" is not comprised entirely of cost items. This, of course, is not true. Opinion No. 468 shows beyond question that the ceiling prices were cost-determined and that

the Commission rejected "non-cost" considerations for designing rates (R. 613d, 614d-615d). But, even if "non-cost" considerations were used, this would not justify designing rates which prohibit generation of revenues equal to revenue requirements, including revenue requirements based on "non-cost" considerations. The gap between revenues and revenue requirements resulting initially from use of an average unit cost as the ceiling rate would still be error, because the Commission's use of the average unit figure as a maximum ceiling price would preclude recovery of total costs or revenue requirements, however derived. Such an agency-created barrier to recovery of total costs is not a "fair relationship." As Justice Jackson noted in the dissent in *Hope:*

> "If we are to hold that a given rate is reasonable just because the Commission has said it was reasonable, review becomes a costly, time-consuming pagent of no practical value to anyone." 320 U.S. 591 at 645 (1944).[19]

By the same token, if a rate can be construed as "reasonable" because the Commission has said that there is a "fair relationship" between revenues and revenue requirements, but at the same time the Commission's own orders *bar* recovery of revenue requirements, *no* lawful standard could exist in area rate regulation.

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[19] See also *State Corporation Commission of Kansas* v. *Federal Power Commission*, 206 F.2d 690, 722 (8th Cir. 1953) *cert. den.* 346 U.S. 922 (1954).

D. Contract Limitations Must Be Considered in Prescribing Maximum and Minimum Rates, as Held by the Court of Appeals

Another attempted justification offered by the Commission for its failure to establish rates based on findings of revenue requirements is the fact that some producer contracts specify prices lower than the Commission's applicable ceiling rates. Recognizing that such limitations exist, the Commission nevertheless refused to adjust its ceiling rates to compensate for these deficiencies, reasoning that it could not lawfully make such adjustment (R. 1114d-1115d). In so doing, the Commission misconceived its regulatory responsibilities and thereby failed to complete its assigned functions. The court below laid bare this error and properly required the Commission on remand to direct its attention to appropriate methods of compensating for such revenue deficiencies.

Although passing references are made in petitioners' briefs to "improvident" low-priced contracts, no real contention is or could be made that producers are to be faulted for the existence of contracts specifying below-ceiling prices. Such contracts have in the past and will in the future result from a variety of conditions over which producers have no control.

As the Commission itself emphasized in its statement of the history of the Permian Basin, most of such contracts result from the former monopsonistic position of El Paso Natural Gas Company as the sole interstate purchaser of gas during much of the development period of this area (FPC Br., pp. 7-9). The Commission's reference to El Paso's "contracting practice" (FPC Br., p. 7, fn. 4) demonstrates that this purchaser did not hesitate to use its dominant position

to dictate the prices which it would pay. In fact, the Commission's statement describes the entry of a second interstate purchaser into this area at prices substantially below those now approved by the Commission (FPC Br., p. 8). It was not until recently that producer prices in this area began to rise to levels approximating even what the Commission now finds to be average costs. Indeed, as the Commission concedes, the enforcement by the Commission of its unilaterally-established 16¢ guideline price after 1960 undoubtedly contributed to the execution of many contracts at prices below the new gas rates now authorized by the Commission (FPC Br., p. 94, fn. 67).

For the future, establishment of ceiling rates cannot be expected *ipso facto* to eliminate the execution of new contracts at prices below authorized ceilings. As the court below noted (XII R. 55), the Commission conceded "that there undoubtedly will be some contract prices lower than the area rate ceiling, as adjusted for quality". There are many reasons, unrelated to improvidence, for execution of contracts at less-than-ceiling rates. Discoveries of new reserves—as desired by the Commission—may be at remote locations which, until additional reserves are developed, do not justify connection by the purchasing pipeline except at a price advantage to it. Quantities available from particular wells may be so low as to make connection uneconomical except at below-ceiling prices. Rather than demonstrating improvidence, the producers' acceptance of below-ceiling prices in such circumstances will result in making available gas reserves which otherwise would be abandoned. As the court below recognized and as is never disputed by petitioners, the occurrence of some contracts at below-ceiling prices is a "fact of life" in

this industry (XII R. 56). Certainly producers cannot be penalized because they are required to accept less-than-ceiling prices under such circumstances.

Regulatory problems posed by these considerations are by no means novel. Nor does compensation for the revenue deficiencies which will inevitably result therefrom involve the Commission in an unlawful exercise of its regulatory powers. Perhaps the most persistent example of a similar situation is the ever-increasing difficulties of the railroads in their attempts to cover admitted costs of passenger train operations through passenger rates. Recognizing that passenger train losses can be recovered only through charges for other services, this Court has upheld the action of the Interstate Commerce Commission in raising intrastate freight rates to offset interstate passenger train losses. *King* v. *United States,* 344 U.S. 254 (1952).[20] The court below delineated the Commission's erroneous concept by referring to *The New England Divisions Case,* 261 U.S. 184 (1923). That court, conceding the

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[20] As the principle has been stated by the I.C.C.:

> "We do not subscribe to the proposition that where freight rates are producing on the property devoted to freight service, the rate of return which has been fixed as fair, we can as a matter of law authorize no increases in such rates to correct deficiencies in aggregate earnings growing out of the inability of the passenger business to meet its full share of the revenue burden. The freight and the passenger services are both essential and both may be subjected to reasonable rates and charges to produce the fair aggregate return authorized by law even though thereby a higher rate of return may be exacted from one than from the other." *Class Rate Investigation,* 262 ICC 447, 658 (1945).

See also the discussion in *Increased Freight Rates,* 276 ICC 9, 32 (1949).

generalities now urged by the Commission, went on to state:

> "At the same time in such group procedures as the division of railroad rates the Interstate Commerce Commission, with court approval, has recognized that revenue from one source may balance that from another." (XII R. 56)

The Commission and its supporting petitioners obscure the inadequacies of the Commission's treatment of this issue by asserting that the court below acted contrary to this Court's decision in *Federal Power Commission* v. *Sierra Pacific Power Co.*, 350 U.S. 348 (1956) (Briefs: FPC 92-96, CPUC 37-41, PG&E, *et al.*, 28-29). But far from derogating that decision, the remand of the court below harmonizes with it.[21]

Arguments that the lower court's action is contrary to *Sierra* rest upon the assertion that the court below unlawfully abrogated contract rates by requiring the Commission to fix minimum rates in excess of contract prices, in order to assure producers of revenues equal to cost, without a finding that the contract rates so increased were so low as to adversely affect the public interest. Such contention misinterprets the decision of the court below and ascribes to it the prescription

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[21] The parties relying on *Sierra* never address themselves to the question of applicability of that case to area regulation. This is a point we need not reach here, but if the Commission were correct in exclusion of all individual company cost information (R. 530d), fulfillment of the *Sierra* test as to sales by individual companies is obviously impossible. Further, there was no element in *Sierra* of a simultaneous reduction of all the other rates above that company's average cost-of-service. See, *e.g.*, *Second Phillips*, 373 U.S. at 310, n. 16.

of minimum rates as a sole remedy. On the contrary, the court below stated the issue in this way:

> "We believe that the controlling question is whether the proper revenue requirements of the area producers as a group can be satisfied with rates having the ceiling and the floor which the Commission has fixed." (XII R. 57)

This language on its face permits the Commission either of two separate choices or a combination thereof. The court below clearly left it open for the Commission on remand, after determining the financial impact of the quality deductions and contract limitations, to apply its regulatory expertise to the question of whether the deficiency should be compensated by increasing the minimum rate upon a finding that the requirements of *Sierra* are met, *or* that such deficiency should be compensated by establishing the ceiling rate at some level above average-cost. The choice is left to the Commission.

Establishment of ceiling rates above average-cost levels to compensate for some sales made at below average-cost levels creates no regulatory problems. This is a technique utilized by regulatory agencies in recognition of the fact that not all services or products can command the same price in the market place. Rates prescribed by regulatory agencies commonly provide a spectrum of individual rates centered around an average cost.[22] Specific revenues provided by this

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[22] Thus, for example, pipeline resale rates typically vary with type of service and load factor. It is only purest coincidence when a given rate at a given time is equal to the pipeline's average cost. An example of such varying rates is seen in *Lynchburg Gas Co.* v. *Federal Power Commission*, 336 F. 2d 942, 944 (D.C. Cir. 1964).

spectrum of individual rates combine to produce average revenues equating to average costs.

In this context, the Commission's assertion that "... low rates for some sales do not warrant excessive rates for others" (FPC Br., p. 93) is but a meaningless abstraction which sheds no light on the issue at hand. As the Examiner in this case pointed out (R. 260d), this argument involves the unsupported assumption that rates higher than average costs are unreasonably high and confuses the issue of the overall level of area rates with the issue of whether an individual rate is unduly discriminatory or preferential.[23]

That rates above average costs are not *per se* excessive was expressly recognized by the Commission in *Second Phillips* (24 FPC 1008, 1009) and affirmed

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[23] The Examiner's statement succinctly exposes the error of the Commission:

> "Staff's argument is that it is improper for some contracts to receive 'more than reasonable rates in order to make up for the deficiencies in others under low price contracts.' In the first place Staff assumes that a rate higher than the average is unreasonably high. Second, Staff confuses the issue of the over-all level of area rates with the issue whether an individual rate is unduly discriminatory or preferential. The reasonableness of area rates concerns the rate level—the average, the maximum and the minimum. Within this framework, the relationship of one rate to another (undue discrimination or preference) is irrelevant to the question of the justness and reasonableness of the over-all rate structure. But Staff does not criticize a single rate on the grounds of undue discrimination or preference. Staff's argument contravenes the very basis of area rates." (R. 260d)

The fact that the Examiner found that existing contract rates were not unduly discriminatory or preferential (R. 268d) assumes significance in the light of the fact that the Commission made no finding to the contrary. *Lynchburg Gas Co.* v. *Federal Power Commission*, 336 F. 2d 942, 948 (D.C. Cir. 1964).

by this Court. It was in fact recognized by the Commission in this proceeding when it expressly authorized rates above average-cost ceilings for gas with above-standard Btu content. Specific rates therefore are not "excessive" unless and until it is determined that the totality of revenues provided by the rate spectrum exceeds revenue requirements.

Nothing in the lower court's decision requires the Commission to permit all contract prices below applicable ceiling rates to be raised to the ceiling. Charges that the Commission is required to compensate for low-priced contracts by permitting producers to "abrogate their contractual commitments and charge the area rate" (FPC Br., p. 92) are addressed to an issue not presented. There is no "abrogation of contract commitments" in the establishment of a ceiling rate at a compensatory level.[24] The question at hand is simply the extent to which contract prices are to be reduced. By requiring all contract prices to be reduced to average-cost ceiling rates, the Commission has required a greater reduction than is necessary or permissible. Reductions in lesser degree to a ceiling rate sufficiently above average cost levels to compensate for below average prices involves no principal contrary to *Sierra*.

In retrospect, the Commission now seeks to absolve its failure to consider the revenue-reducing impact of below-ceiling contracts by unsupported and unsupportable assertions that revenues will in fact meet revenue requirements. Such contentions effectively

[24] To the extent that reduction of contract prices constitutes "abrogation of contract commitments", such reduction, if otherwise proper, falls within the admitted scope of the Commission's powers to establish maximum prices.

concede the validity of the legal principles stated by the court below. They demonstrate also the failure of the Commission to complete its regulatory assignment. In its brief, the Commission would have this Court believe that the Commission, in fact, made specific findings to the effect that revenue deficiencies from below-ceiling prices were, in effect, compensated for by the prescribed ceilings. Thus, the Commission's brief asserts that actual revenues for the test year were "but a shade below the 13-cent average that the Commission expressly found to be just and reasonable." (FPC Br. p. 96) As we show in more detail *infra,* no such express finding exists.[25] But even if it could be inferred, the Commission's present assertion refers to revenues actually received, without giving effect to the impact of its required reduction of all above-ceiling contract prices to average-cost ceiling rates. Under the Commission's order, realizable revenues would be forcibly depressed below the experienced level by reason of the fact that many contract prices which contributed to test year revenues must now be substantially reduced.

The court below properly left to the Commission's administrative expertise the selection of the precise method by which the producer group revenue requirement is to be met. The error of the Commission lies in failing even to inquire as to the impact of its dual revenue-reducing order, *i.e.,* reduction of above ceiling prices and deductions for quality differentials.

The court below has simply required the Commission on remand to complete its unfinished task by

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[25] No citation to the record is or can be offered for such alleged "finding". We discuss this alleged "finding" in detail, *infra,* pp. 47-50.

further adjustment of minimum prices *or* by adjustment of ceiling prices to levels which, within contract limitations, will produce the necessary total revenues, *or* by a combination of the two. Absent regulation, when contract prices were not high enough to generate revenues equal to revenue requirements, a deficiency of revenues is unavoidable.[26] However, the Commission may not lawfully force a future revenue deficiency by fixing maximum rates which ignore factors that will prevent sales of all gas at ceiling rates.

E. The Attempt of Commission Counsel To Show That Test Year Average Revenues Are in Approximate Balance With Revenue Requirements Is Misleading and Without Evidentiary Support.

As we have shown, the Commission did not determine the impact which its rates would have on the revenues of the Permian Basin producers. This cardinal omission compelled remand by the court below. In their brief, however, Commission counsel attempt to remedy that omission by claiming that test year revenues and revenue requirements are in approximate balance.

We urge the Court to analyze with care the assertions by Commission counsel of approximate balance between revenues and revenue requirements (FPC Br., p. 96), a suggestion which the Commission itself expressly rejected (R. 1114d):

> "The application by the Major Producers refers to 'the Commission's finding that jurisdictional revenues will equate to jurisdictional costs.' The Commission made no such finding."

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[26] As we develop later, the Commission should not be permitted to compound this deficiency by the imposition of refunds.

Acceptance of that assertion could mislead and cause serious factual error regarding a most important aspect of this case.

Counsel for the Commission "conclude" that the Commission was unconcerned in its decision with the impact of its rates upon revenues because, they say, "there is empirical confirmation" of the revenue-revenue requirement balance resulting from their views that (FPC Br., p. 96):

(1) The average unit revenue for 1960 volumes, using rates on file at the end of that year for old gas-well gas for which quality statements have been filed, was 12.9 cents per Mcf;

(2) This 12.9-cent revenue "is but a shade below the 13 cents average [unit revenue requirement] that the Commission expressly found to be just and reasonable";

(3) The "base rate" was 14.5 cents, but the quality deficiencies "result in an average rate of 13¢" (FPC Br. p. 96, fn. 71).

We are unable to verify from the record the 12.9-cent revenue figure referred to in the Commission's brief.[27] However, the error is exposed upon analysis of counsel's claim that the Commission "expressly found"

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[27] The record reflects that the average test year revenue was 12.72 cents (Exh. 175, R. 538e). We are puzzled also by Commission counsel's reference to rates for "gas for which quality statements have been filed." Since the quality statements were *not* filed until long after the entry of the Commission's decision, the data from the quality statements could *not* have been utilized by the Commission for *any* purpose. If such reference merely defines the volume of gas which is now alleged to have an average revenue of 12.9 cents per Mcf, it is clear that such volume was unknown to the Commission, and the comparison now made was *not* available to the Commission when it rendered its decision.

the "13-cent average" to be "just and reasonable" (FPC Br., p. 96).

The Commission specifically found, under the title "Summary of the Cost of Flowing Gas," that the cost of such gas for the test year 1960 was 14.39 cents (R. 639d), which it rounded to 14.5 cents (R. 645d). The question is thus posed: How does this 14.39-cent cost figure in the decision somehow now become 13 cents in the Commission's brief?

The answer apparently is to be found in the turnabout treatment which the brief, *vis-a-vis*, the decision, accords the quality deductions. We are surprised to find that counsel now treats the quality deductions as a "benefit" to producers, employing those deductions to reduce the rounded cost of 14.5 cents to 13 cents; whereas, of course, the fact is that the opposite is true when it comes to applying the cost deductions. They operate to reduce producers' revenues, *not* producers' costs.

Counsel therefore are in grievious error in attempting to imply or force a balance between revenues and revenue requirements by deducting 1.5 cents for quality deficiencies from the cost side, rather than from the revenue side. Assuming that it is proper to use this deduction in equating cost and revenues, the 1.5-cent quality deduction should be subtracted from their figure for producers' average 1960 unit revenue of 12.9 cents, rather than subtracting it from producers' average cost. By this application, the average revenue would be reduced to 11.4 cents per Mcf.[28] Commission

[28] Average unit revenue under the Commission's prescribed ceilings will be much less than 11.4¢ as a result of the reduction of *all* rates in the test year above the applicable area rate level to such levels. Further reductions have flowed from refunds and rate reductions in settlement proceedings since 1960 (see *infra*, p. 73, fn. 55).

counsel thus arrive at a wholly distorted comparison of costs and revenues by erroneously reducing an average cost by the estimated average quality deduction and then compound the error by failing to reduce the average revenue figure to reflect the impact of quality deductions. A more nearly accurate measure of the Commission's failure to provide for cost recovery is the difference between the 14.5-cent average cost and some unknown revenue figure, necessarily below 12.9 cents per Mcf.

The distortion is further magnified by the fact that the Commission itself did not include in its average costs computations the producers' cost of converting sub-standard gas into pipeline quality gas. We treat elsewhere in our discussion of rate of return with the Commission's error in this regard. By failing to include the cost to producers of bringing sub-standard gas up to pipeline quality gas, and then illogically deducting pipelines' costs from the resulting understated producers' costs, rather than from producers' revenues, where the impact thereof actually lies, Commission counsel thus have devised a patently invalid revenue-cost comparison.

F. Use of Group Procedures Does Not Permit Discard of the Statutory Standard or Imposition of Rates Barring Recovery of Required Revenues.

As we have shown, the Commission has not followed required steps outlined in *Federal Power Commission* v. *Natural Gas Pipeline Co. of America,* 315 U.S. 575, 584, 586 (1942) of "adjustment of the general revenue level to the demands of a fair return," and *then* adjustment of rate schedules to conform rates to *that* revenue level and to eliminate "discrimination" and "unfairness" in details. Consequently, the rates al-

lowed do not comport with *Hope: rates* cannot provide "enough revenue" for (1) "operating expenses," (2) "capital costs" including "service on the debt and dividends on the stock," and (3) a return allowance "commensurate" with that on "investments in other enterprises having corresponding risks," and "sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital" (320 U.S. at 603).

Nevertheless, certain petitioners argue that these steps and findings can be eliminated from group rate procedures. This would mean that, under the area method, the true function of a rate would be ignored, and the objective of group procedures under any statute—determination of required rate levels to be used in design of rates—would never be reached.

This Court has had but one occasion to consider a producer rate case since 1954,[29] but the courts of appeals long have recognized that, consistent with *Hope,* the substantive standard of the Natural Gas Act must be applied in producer regulation in terms of the function of a rate in this industry. Thus, in *Forest Oil Corp.* v. *Federal Power Commission,* 263 F. 2d 622 (5th Cir. 1959), the court summarized ingredients of a "just and reasonable" rate in the context of a producer case. Items included are a fair return on the

[29] In *Second Phillips,* the merits of a Commission final order under Sections 4 and 5 of the Act were before the Court. There, the Commission had followed lawful rate review and testing procedures: (1) determination of costs and revenue requirements, (2) comparison of revenues at existing rates with revenue requirements, (3) review of the range of rates as to discrimination, and (4) termination of its proceedings upon findings that existing rates did not exceed cost-of-service and were not discriminatory. Rejecting attacks upon this disposition, this Court found no error.

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investment, amortization costs, interest, earnings on plant investment, cost of the producer's interest in gas in place, cost of facilities, and cost of exploration and development representing "the cost of finding potential fields as well as the drilling of the dry wells that seems to be a necessary part of any continuing oil or gas business" (263 F. 2d at 625). As that court stated, the substantive question which must be answered in a given case therefore is ". . . whether a proposed rate is just and reasonable to the public and is not too low to yield a fair return on the producer's investment and a reasonable increment for exploration and development" (263 F. 2d at 626).

The shift to group rate regulation does not mean that rates can be prescribed without regard for such revenue requirements of the group. The Commission proceeded, as shown, to aggregate costs to determine, by averaging, an industry experience of cost incurrence. In that endeavor, presentations were addressed to the appropriate allowances for each item of necessary expenditure in exploration, development and production—the objective being a tabulation of these components to arrive at an aggregate cost to be used in rate design.[30] The Commission selected these

[30] Despite statements that certain of the Commission's figures appear "generous," all of the Commission's supporters hasten to assure this Court that allowances for these expenditures—including dry hole expenses and other exploration and development costs—*should* be included. PG&E, *et al.* thus state, in terms similar to the words of the court in *Forest:* "It is not our position that the Commission should not have included such expenses in the yardstick costs used to set rates. Such expenses are necessarily incurred in the finding and production of gas." (PG&E, *et al.*, Br., p. 16, fn. 10; see also CPUC, *et al.*, Br., p. 22).

Moreover, the Commission brief miscites *Columbus Gas & Fuel Co.* v. *Public Utilities Commission of Ohio,* 292 U.S. 398 (1934)

elements as its "yardsticks" of financial requirements of the industry. These figures cannot be discarded in rate design since, under regulation, producers' cost recovery depends upon rate levels *prescribed* by the Commission. It also follows, as concluded by the court below, that if these tabulations were *not* the Commission's findings of revenue requirements in this case, the Commission erred in failing to make required findings. If, on the other hand, as the Commission opinion indicated, these tabulations *do* represent the Commission's conclusions as to revenue requirements, the Commission erred in failing to design rates consistent with such findings. Otherwise, there is no purpose to the group proceeding.

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for the proposition that a producer "has no constitutional right" to reimbursement for "dry-hole expenses" (FPC Br., p. 59). The Commission did *not* decide that constitutional issue in *this* case; the question obviously is not ripe for review here because allowance for these expenses *was* included in Commission computations; and the question will come before the Commission or the courts only if the Commission proceeds otherwise in passing on a petition for exemption from an area rate.

We also note (1) *Columbus* did *not* involve dry-hole expenses but a question of inclusion in rate base of capital investment in "unconnected leaseholds" by a state commission; and (2) such properties have been considered "used and useful," and allowances for dry-hole expenses also have been *included*, consistently in determining "reasonable" rates under the Natural Gas Act (see *Federal Power Commission* v. *Natural Gas Pipeline Co. of America*, 315 U.S. 575, 588 n. 6 (1943); *Federal Power Commission* v. *Panhandle Eastern Pipe Line Co.*, 337 U.S. 498, 507 (1949); *Phillips Petroleum Co.*, 24 FPC 537, 555, 565 (1960)).

As noted by the court below: "Exploration and development are financed out of current income and are charged to expense rather than capital" (XII R. 31). If no provision were included for these expenses in fixing "reasonable" rate levels which control "current income," the activity inevitably would cease, as the Commission itself has recognized in its administration of the Act for the past thirty years.

Experience with group procedures under other statutes illustrates the errors in rate design in this case. As decisions reflect, the Interstate Commerce Commission long has used "general revenue" cases to determine aggregate "revenue requirements" of a group and "general rate" cases for adjustment of bodies of rates within the framework of a known revenue requirement.[31] Under these procedures, overall rate levels, divisions of rates, and rates for classes of services are considered on a group basis—the objective still being findings to be *used* in prescribing rates. In *The New England Divisions Case* (*Akron C. & Y. R. Co.* v. *United States*), 261 U.S. 184 (1923), this Court thus referred to use of evidence "typical in character and ample in quantity to justify the finding made in respect to each division of each rate of every carrier" (261 U.S. at 197), and later to requirements that where "aggregate results" are considered, impact must be considered in terms of the statutory standards, *United States* v. *Abilene & S. R. Co.*, 265 U.S. 274, 291 (1924).[32] While the agency is *not* required to make findings as to "impact" upon *each* carrier *within* a group, the agency nevertheless does make findings as to *aggregate* "costs," *aggregate* "needs," and *aggregate* "revenue requirements" *for the group of affected carriers,* and then proceeds to translate *these findings* into rate structures resting upon connection of revenues with required revenue levels. See *Chicago*

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[31] See Aitchison: *Fair Reward and Just Compensation, Common Carrier Service, Standards Under the Interstate Commerce Act* (1954), pp. 4-7.

[32] As to such findings in a railroad "general revenue" case, see *United States* v. *Louisiana*, 290 U.S. 70, 75-78 (1933), and in a motor carrier "general revenue" case, see *Increased Common Carrier Truck Rates in the East*, 42 MCC 633, 648 (1943).

& N. W. R. Co. v. *Atchison, T. & S. F. R. Co.*, 387 U.S. 326 (1967).

Similarly, under the Bituminous Coal Act reviewed in *Sunshine Anthracite Coal Co.* v. *Adkins*, 310 U.S. 381 (1940), the agency was authorized to fix "maximum prices" at a uniform increase above "minimum prices" so that in the aggregate, the body of prices would yield a reasonable return *above* a weighted average total cost. "Minimum prices" would be fixed after determination of "weighted average cost for each minimum price area," of classification of sizes and grades, of "relative market values," and of "a return to each area approximating its weighted average cost per ton . . ." (310 U.S. at 397).

Under other statutes, such findings as to aggregate requirements are *not* discarded.[33] Findings are translated into rate levels either by agency ordering of specified percentages of reductions or increases in existing rates, or by orders to regulated companies to file rates bringing revenues in line with findings as to revenues required.[34] Here, however, the gaps between

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[33] See cases cited in n. 32, *supra*. The practice is similar where a single company is used as a "bellwether" to determine a group requirement. Customarily, other companies in the group, as well as the "bellwether," are directed to file revised tariffs bringing their earnings to the level found "reasonable" in the agency's findings as to the "bellwether." See *Western Union Telegraph Co.*, 25 FCC 535 (1958) and *Postal Telegraph-Cable Co.*, 5 FCC 524 (1938).

[34] In *Anglo-Canadian Shipping Co., Ltd.* v. *Federal Maritime Commission*, 310 F. 2d 606, 615 (9th Cir. 1962), the court stated: "Whether the number of respondents before the Commission be one or sixty or one thousand, there is no exception to the requirement of § 8(b) [of the Administrative Procedure Act] for findings sufficient to support the Commission's order". The court there reversed the Maritime Commission for failure to make adequate findings as to the revenue impact of its order.

Commission expressions of theory and the rates actually prescribed are such that expenses may or may not have been properly allowed "as part of the composition of the rates," and "the so-called allowance of a return upon the investment, being an amount over and above expenses" may well be but a "farce." *Mississippi River Fuel Corp.* v. *Federal Power Commission,* 163 F. 2d 433, 437 (D.C. Cir. 1947). Such gaps can never be filled by general statements, as the District of Columbia Circuit, after listing the elements discussed earlier in *Hope,* has aptly stated:

> "The Commission in its opinion recognized that, 'in the final analysis, the matter of fixing just and reasonable rates involves a balancing of the investor and the consumer interests'; and we do not doubt its purpose to find that balance. Our difficulty, as we have said, arises from the Commission's failure to provide us an adequate basis for knowing why it did what it did." [35]

The same difficulty exists here. When the Commission shifted to the area method, the shift was made with assurances that area rates would be prescribed with full recognition of the financial or revenue requirements of the producing industry in a given area. These assurances were expressed by Commission policy statement, in argument before this Court, and in orders establishing evidentiary guidelines in this case.[36] Con-

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[35] *D.C. Transit System* v. *Washington Metro. Area Transit Commission,* 350 F. 2d 753, 780 (D.C. Cir. 1965). See also *Burlington Truck Lines, Inc.* v. *United States,* 371 U.S. 156 (1962); *Interstate Commerce Commission* v. *Mechling,* 330 U.S. 567, 583 (1947); *Eastern-Central Motor Carriers' Association* v. *United States,* 321 U.S. 194, 211-212 (1944); *Northeast Airlines, Inc.* v. *Civil Aeronautics Board,* 331 F. 2d 579, 586 (1st Cir. 1964).

[36] See references in *Wisconsin* v. *Federal Power Commission,* 373 U.S. 294 (1963) and R. 541d.

sistent with these expressions, the Examiner in this case stated objectives of valid design of area rates:

> "The total revenue to be realized is, of course, the volume of gas times the revenue standard. The rate design problem is first, to insure that the rate structure is such that producers can reasonably obtain these revenues, and second, that the price structure properly reflects price differentials for the different qualities and values of gas. Rate design is concerned with insuring that producers as a group have a practical opportunity to realize the revenue standard under their contracts and with the distribution of that total amount among the various contracts." (R. 244d)

The Commission, however, rejected the Examiner's rate system, forgot its assurance to this Court in *Second Phillips*, and ignored the record evidence as to the relationship between revenues and its own findings as to "aggregate costs producers incur" and "overall costs" in the area.[37] Such a disregard for required rate testing cannot be approved merely because group procedures are used. All of the Commission's elaborate cost computations are useless if they do not represent findings as to revenue requirements and if rates can be prescribed without actual use of such findings. Here, the purpose of using group procedures to prescribe rates consistent with aggregate requirements has been ignored.

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[37] The Commission did have before it evidence to compare average revenues with maximum rates based on averages of costs: (1) Exhibit 317-A indicated that the weighted average price of *new* gas-well gas contracts for the two and one-half years after January 1, 1961, was approximately 15.4 cents, which is less than the Commission's 16.5 cents rounded average costs (R. 1093e); (2) Exhibit 175, R. 535e, indicated that the average unit revenue in 1960 from all flowing gas was only 12.72 cents, which is less than the Commission's rounded average cost for this type of sale of 14.5 cents.

II. RATE-OF-RETURN REMAND BY THE COURT BELOW WAS INESCAPABLE.

Dealing generally with industry production activities—not restrictively with pipeline-quality gas in the Permian Basin area—the Commission adopted as reasonable a 12-percent rate of return, following a detailed analysis along conventional lines (R. 597d-606d). From the ceiling rates it thereafter fixed, the Commission provided for downward adjustments for gas of less than pipeline quality (R. 645d-656d). Because of admitted lack of evidence of impact of these quality deductions and because the Commission treated quality deductions as an item of risk rather than as an item of cost (XII R. 53-5), the court below remanded, saying (XII R. 60):

> "The facts sustaining the conclusion of fair relationship must be found. The Commission did not make those findings and indeed it could not have done so because of the failure of the record to disclose the revenue impact of the adjustments in area rates to reflect quality differentials. Whether rate reductions because of quality deficiencies are a risk or a cost, the answer comes out the same. If they are a risk, we do not know the rate of return. If they are a cost, we do not know whether the revenue received will equal the reasonable revenue requirements."

Thus, the absence of findings showing the rate of return actually allowed by the Commission prohibited the court below from performing the review function contemplated by *Hope*.

It is evident from the outset that the Commission's diminishing of the return allowance through quality

adjustments made it impossible for producers to earn the 12-percent return which the Commission found to be reasonable.[38] This fatal defect is unaffected by whatever the subsequently developed facts might show as to the exact amount of the deduction, for the earning of the 12-percent return is barred to the extent of whatever the deduction.

In their brief to this Court, Commission counsel first concede and then demonstrate the accuracy of the analysis of the court below. The concession lays "stress" on their argument that "the 12-percent rate fixed by the Commission was never expected or intended to denote the average return that would be earned by sales of gas-well gas in the Permian Basin."[39] The demonstration that the 12-percent return cannot be earned appears when the risk of finding gas of less than pipeline quality is "translated" into terms of rate of return, Commission counsel admitting "that the prescribed area rates might yield as little as about 10¾ percent overall" on average quality new gas-well gas, and "possibly only slightly more than 9 percent overall" on average quality old gas-well gas

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[38] The producing industry's inability to realize average revenues equal to the Commission's determined average costs levels, and thereby earn the prescribed 12% return, is compounded by the establishment of *ceiling* rates at *average* cost levels in disregard of contract limitations. This is more fully developed at pp. 35-38, *supra*.

[39] FPC Br., p. 140, omitting a footnote stating that no separate return was computed for oil-well gas.

(FPC Br., p. 141).[40] We note that these percentage calculations are presented by Commission counsel and do not appear in the Commission's opinion.

The essential keystone for this effort by counsel to extricate the Commission from the dilemma exposed by the court below is the disingenuous claim that the Commission's 12-percent rate was restrictively limited to "gas of pipeline quality" (FPC Br., pp. 140, 147). This is the sole defense urged. It is counsel's rationale, not that of the Commission. Acceptance by a reviewing court of counsel's rationale as a substitute for omitted Commission findings "would deprecate the administrative process for it would 'propel the court into the domain which Congress has set aside exclusively for the administrative agency.'" *National Labor Relations Board* v. *Metropolitan Life Insurance Co.*, 380 U.S. 438, 444 (1965).

Moreover, this claim collides with the fact that the return allowance is computed—traditionally and by the Commission here (*e.g.*, R. 606d)—by applying the percentage rate-of-return figure to an investment rate base, not to "pipeline-quality" gas for which of course

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[40] Overall return at 9-10¾% would produce a return on equity investment for producers in the range of 10-11.5% (R. 196d). This compares with the Commission's allowance to pipelines of return on equity of 10-12% (R. 599d; see also FPC Br., p. 144, footnote 16). The 9-10 ¾% overall return for producers, now urged by Commission counsel, would allow producers no more than, if as much as, the Commission allows pipelines on equity. This is wholly inconsistent with the Commission's express findings that production operations generally involve greater risk than pipeline operations, and that producers should therefore be allowed a greater return than pipelines (R. 600d). This express finding, made after comparing returns on equity, necessarily includes the allowance to pipelines for whatever additional risk is caused by greater reliance on borrowed capital.

no separate rate base was computed. But even if this inherent incongruity be overlooked, the claimed restriction is both unsupported and insupportable.

The Commission's brief made no effort to show that the Commission actually found that its 12-percent return was restrictively limited to pipeline quality gas.[41] Indeed, proof to the contrary appears in that part of the record alleged and cited to support this statement (FPC Br., p. 140):

> "The Commission concluded that a 12-percent overall rate of return *for gas of pipeline quality* was appropriate; that it would protect 'gas consumers against excessive prices' yet be sufficient 'to respond to the needs of the industry' (R. 606d)."

But the conclusion actually reached by the Commission did *not* relate to pipeline quality gas—as counsel now say—but to production activities without regard to quality of gas producer (R. 606d):

> "A return of 12 percent on *production activities* protects gas consumers against excessive prices but it is not so low that it fails to respond to the needs of the industry."

When the claim is later repeated (FPC Br., p. 147), there appears a reference to the entirety of the Commission's rate-of-return discussion (R. 575d-606d) and to the corresponding discussion in the decision of the

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[41] A similar and related statement, for which no support is or could be cited, is the claim in the brief that 14.39 cents per Mcf is the "unit cost found for pipeline quality gas" (FPC Br., p. 142). The record shows, emphatically to the contrary, that this is the "cost of flowing gas"—not gas of pipeline quality (R. 639d).

Examiner (R. 191d-212d). But the discussion by the Examiner includes no suggestion that his 12-percent rate of return was intended to be limited—as Commission counsel now suggest—to gas of pipeline quality. To the contrary, as the Commission's brief to this Court correctly noted three pages earlier (*id.*, p. 144), "[T]he examiner concluded that 12 percent was appropriate for gas of the *average quality* produced in the Permian area."

Similarly, the Commission's extensive discussion of rate of return nowhere suggests that its 12-percent rate was intended to be restricted to gas of pipeline quality (R. 597d-606d). To the contrary, that discussion includes a paragraph regarding the risk in Permian of finding gas below pipeline quality and the reason why the Commission considered this risk in establishing its 12-percent rate of return (R. 602d). Obviously, that entire paragraph would be incongruous if the 12-percent rate were intended to be restricted to gas of pipeline quality, as Commission counsel now contend.

The claim that 12-percent rate was intended to be restricted to gas of pipeline quality simply cannot be squared with an analysis of what the Commission actually did. As already noted, proceeding along conventional lines and dealing generally with production activities in the Permian Basin area, the Commission adopted a 12-percent rate of return (R. 597d-606d). Allowing a 12-percent return, it developed a return component of 4.99 cents per Mcf in summarizing historical Permian area "production costs" for old gas-well gas (R. 634d), "the basic yardstick for establishing a single ceiling applicable to all gas other than new gas-well gas" (R. 625d). This production cost figure was used in its "Summary of Cost of Flowing Gas"—

not gas of pipeline quality—in an amount of 14.39 cents per Mcf (R. 639d). Relying expressly on this "historical cost determination," the Commission fixed a ceiling rate for flowing gas of 14.5 cents per Mcf (R. 645d). This is the flowing gas rate to which the Commission applied its adjustments for quality differentials (R. 645d-656d).

In other words, proceeding along conventional lines and considering production activities in Permian generally, the Commission adopted a 12-percent rate of return. It expressly stated that its determination rested, in part, upon a consideration of the risk that the Permian producers might find gas of less than pipeline quality. This is the return allowance employed by the Commission in its determination of the historical cost of flowing gas, only a fraction of which is of pipeline quality. However, in its design of rates, the Commission prescribed deductions for gas of less than pipeline quality. In so doing, it plainly foreclosed the possibility that producers could earn the 12-percent rate of return which the Commission determined to be reasonable. But nowhere in this sequence of things which the Commission actually did is there any suggestion that its adopted rate of return was appropriate only for "gas of pipeline quality," and the suggestion is belied by that sequence.

The state of the record thus made it impossible, as the court below found, "to appraise the allowance made by the Commission" (R. 60). The extent of the impact of the quality deductions required by the Commission's order is not known or in the record, as the Commission expressly conceded (R. 604d).

Nor is the Commission's position improved by the variety of estimates on which it now relies (FPC Br.,

pp. 141-2). The Examiner estimated one cent to cover the cost of bringing new gas-well gas up to pipeline quality, and 1 cent to 1.5 cents for old gas-well gas (FPC Br., p. 143). Having made no findings of its own, the Commission dealt with this point on rehearing by referring to an estimated average adjustment—based on contract revenue differentials and not on actual cost experience—within a range from 1.0 cents to 1.7 cents, as set out in the concurring and dissenting opinion of Commissioner O'Connor (R. 1115d).[42] With changes of its own, the Commission estimated that the average adjustment would range from 0.7 cents to 1.5 cents (*ibid.*). Commission counsel now state that, "for every 1 cent quality reduction, the return allowance would be reduced by only about 0.8 cents" (FPC Br., p. 141); this is almost one fifth of the 4.99-cent per Mcf return allowance which the Commission determined to be reasonable in the case of flowing gas (R. 634d). It is thus obvious that the court below could not appraise the return allowance assertedly made by the Commission.

The more important point, however, is the fundamental fact that—whatever the amount of the quality deduction—the producers are commensurately denied

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[42] The Commission's initial opinion specifically noted that the "record is deficient as to the overall financial impact" of the quality adjustments (R. 614d). In our application for rehearing, we noted that this deficiency prevented a test of sufficiency of the rate of return purportedly allowed (R. 907d-908d). The Commission responded that "The record does not leave us as much in the dark in this matter as the producers would have us believe" (R. 115d), pointing to Commissioner O'Connor's estimates. But he did not and could not then know the costs incurred by the pipelines in bringing gas up to pipeline quality. Instead, he made estimates based on "contract exhibits" as is evident from his opinion (R. 746d).

the possibility of earning the necessary 12-percent return held by the Commission to be reasonable. Put aside the controversy suggested in the Commission's brief as to the acceptability of the variety of the estimates as to the impact of the quality adjustments (FPC Br., p. 142). Put aside any argument as to whether, in appraising that impact, the Commission's brief may properly depend upon facts unknown and outside the record (*id.*, pp. 141-142).[43] There remains the inescapable fact that the Commission's imposition of a quality deduction in its design of rates absolutely forecloses an opportunity that the producers can earn the 12-percent return held to be reasonable, and this foreclosure is commensurate with whatever the impact of the quality deduction. This means that the rate of

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[43] Even if it were proper to rely upon post-record "facts" respecting the impact of quality deductions based on pipeline costs, sheer speculation is required to conclude that the Commission's decision on quality deductions would be unaffected by a knowledge of such costs and their nature.

This is the speculation implicit in the Commission's brief when it relies upon the Commission's order accepting quality statements, issued January 6, 1967, in Docket Nos. AR61-1, *et al.* (FPC Br., pp. 141-2, 18). A few references to that order will illustrate.

In the case of old gas-well gas, the maximum single deduction is 5.71 cents per Mcf. The maximum add-on is 1.56 cents per Mcf. This produces a total spread of 7.27 cents per Mcf, or more than half the average cost of old gas-well gas. Producers accounting for 38 percent of the volume suffer approximately 80 percent of the quality deductions. In the case of old residue gas, the maximum single deduction is 3.18 cents per Mcf, and maximum single add-on is 2.11 cents per Mcf. This produces a total spread of 5.29 cents per Mcf.

We need not attribute significance to the foregoing figures. But they do show that use of unsifted averages can conceal weird circumstances, all unknown to the Commission when it adopted its order. No one can know whether, with knowledge of such facts, the Commission might have reached different conclusions.

return actually allowed to the producers is 12 percent minus "x."

It is correspondingly true that the Commission's rate design thus makes impossible a recovery of producer costs in the aggregate. The Commission found a cost of flowing gas-well gas in Permian of 14.39 cents per Mcf (R. 639d). This is not the cost of pipeline quality gas, but represents the general experience in finding and producing the entire mixture of Permian gas (R. 624d-639d). Most Permian gas is below pipeline quality.[44] Based expressly and directly on this historical cost finding, the Commission fixed its ceiling price for flowing gas of 14.5 cents (R. 645d). But this rate will be denied to all but a fraction of flowing gas in the Permian Basin. Thus, through "quality deductions," the Commission's rate design bars producers from recovering their costs.

In fact, and contrary to the argument of Commission counsel that the 12-percent return was intended only for pipeline quality gas, their brief demonstrates that the average-cost producer—if there were one—cannot earn 12 percent even from the sale of pipeline quality gas. They argue that producers are not denied the cost of bringing subquality gas up to pipeline standards, the theory being that such costs are recoverable through receipt of the higher ceiling price for pipeline quality gas (FPC Br., pp. 157, 161-2). But the producer must incur additional costs to bring his gas up to pipeline quality and thus receive the maximum ceiling price. But since these additional costs are not included

[44] R. 602d. The court below concluded that about 90 percent of all Permian gas was below pipeline quality (XII R. 52; see also R. 909d, 911d).

in determining the ceiling price, as Commission counsel admit, part of the allowed return will be consumed to pay these costs. The resulting actual return is thus reduced below 12 percent, and the 12-percent return is fictional even as to pipeline quality gas.

The Commission's treatment of the cost of bringing gas up to pipeline quality is puzzling in still other respects. In its analysis of the rate-of-return requirement, the Commission properly took cognizance of the uncertainty that the individual producer would find gas in commercial quantities, even though the Commission properly included in aggregate costs the operating expenses incident to dry holes (R. 601d).[45] Correspondingly, there can be no question as to the propriety of including in aggregate costs such expenses as producers incurred in bringing gas up to pipeline quality, even though the determination of a proper rate of return takes express cognizance of the risk that the individual producer may find gas of less than pipeline quality. The Commission's brief thus misleads in noting that processing costs in Permian are typically incurred by the pipeline, not the producer (FPC Br., p. 143). This is the cost of the pipeline which the Commission now says "should be borne by the producer as a discount from the ceiling price" (*id.*, p. 141). Lack of logic to one side, and overlooking the fact that no one's processing costs were included in the exclusively producer costs on which alone the Commission based its Permian rates, it is evident that imposition of this quality-deduction penalty has the direct effect of denying to producers the required oppor-

[45] There is thus a manifest contradiction in the assertion in the Commission's brief that this individual risk for finding dry holes is "mitigated" by inclusion of the related expenses in the aggregate costs (FPC Br., p. 145).

tunity to earn the 12-percent return found by the Commission to be reasonable and also of denying to them the required opportunity to recover through revenues those costs determined by the Commission actually to have been experienced by the Permian producers.

The foregoing and other considerations collapse the Commission's suggestion that "the return is adequate" (FPC Br., pp. 144-148).[46] That suggestion may be placed in perspective by reference to data which the Commission itself characterized as providing "the best record indication of what the production function traditionally returns," data which it held entitled to "heavy consideration in the decisional process in this case" (R. 604d). These data for the years 1957-1961 showed that nine companies with operations confined to production functions experienced an average return of 12.4 percent; that seven Permian producers experienced an average return of 13.4 percent; and that another group of 13 producers engaged solely in production experienced an average return of 14.5 percent (*ibid.*). Considering these "best record" and other indications, the Commission prescribed a 12-percent rate of return as reasonable. But even that minimal rate is barred to producers through the device of the quality-differential penalties.

No more is needed to show that the Commission did not satisfy the requirements of *Bluefield*[47] and *Hope*,[48]

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[46] For the reasons already developed, the conclusion of the court below to remand for rate-of-return deficiencies was inescapable. It is therefore unnecessary to deal point-by-point with claims that the return is adequate (FPC Br. 144-150). We deny those claims and limit our response here to illustrative comment.

[47] *Bluefield Water Works & Improvement Co.* v. *Public Service Commission of West Virginia*, 262 U.S. 679, 692-693 (1923).

[48] *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591, 605 (1943).

the controlling principles of which were expressly recognized by the Commission.[49] Nor can an answer be found in generalized references to the "end-result" test, for it is settled that:[50]

> "The 'end result' is the ability of the rate to meet the sum of the costs required to conduct the operation in fairness to the consumer and to the company."

Here, the quality deductions from the rate fixed pose an absolute bar to the collection of revenues adequate to cover the costs found by the Commission.

For all of these reasons, the conclusion of the court below to remand on rate of return was inescapable. The Commission's determination plainly did not conform to the legal principles which it recognized as controlling. The court's conclusion that it had "no basis on which to appraise the allowance made by the Commission" (XII R. 54) is a gentle understatement.

III. THE DECISION OF THE COURT BELOW THAT REFUNDS ARE PROPER FOR ONLY THOSE PERIODS IN WHICH GROUP REVENUES EXCEED GROUP REVENUE REQUIREMENTS CORRECTLY APPLIES THE DECISIONS OF THIS COURT AND ASSURES THAT CONSUMERS WILL NOT PAY EXCESSIVE GAS PRICES TO PRODUCERS.

A. The Court Correctly Concluded That, in an Area Rate Proceeding in Which Ceiling Rates Are Arrived at on the Basis of Aggregate Industry Costs, Refunds Are Proper Only if Group Revenues Exceed Group Revenue Requirements.

As with the question of rate reductions, the court below properly concluded that the end result test must be applied to the periods of time in which the increased rates were in effect. The Commission ordered refunds

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[49] R. 598d; FPC Br., pp. 147-148.

[50] *Mississippi River Fuel Corp.* v. *Federal Power Commission*, 163 F. 2d 433, 451 (D.C. Cir. 1947).

throughout the "locked-in"[51] period on an individual contract-by-contract basis wherever the increased rate exceeded the "applicable area rate," without considering whether industry revenues under such increased rate were more or less than the area producers' revenue requirement during the locked-in period. Thus, the Commission deemed revenues resulting from the rates as increased to be irrelevant, and applied as the sole refund criterion the mere circumstance that the individual increase exceeded the prescribed rate.

On reconsideration, the court below reached the only result logically possible—in group ratemaking, the end result test is applicable and requires an analysis on a group basis of revenues and revenue requirements during the locked-in period. Accordingly, the court held that refunds are proper only as required to eliminate excessive group revenues. The court concluded that, for periods in which group revenues exceed group revenue requirements, refunds may be ordered on some equitable contract-by-contract basis, and a remand was ordered to enable the Commission to make this analysis.[52] The court's conclusion is, we submit, the

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[51] The "locked-in" period in this case is that interval between the date the first increased rate was put into effect under Section 4(e) of the Act and the effective date of the Commission's order herein pursuant to Section 5(a) of the Act (September 1, 1965). The Commission's order recognizes this as the "locked-in" period in this proceeding (R. 691d; 695d-696d; 1119d-1120d).

[52] XII R. 89. The court's language is ". . . no refund obligation may be imposed for a period in which there is a group revenue deficiency. When group revenues exceed group revenue requirements, refunds may be ordered on some equitable contract-by-contract basis." Thus, the appropriate "period" is left to the Commission's discretion. Since the Commission used an annual period (calendar 1960) for the test year, we assume annual periods would be appropriate. This was the approach taken by the Examiner (R. 266d-267d).

only proper one in an area proceeding; otherwise, under the guise of refunds, the Commission is free to defeat the end result test and to deny to the regulated entity the revenues which the Commission itself has determined to be appropriate for it.

Contrary to the claims of petitioners, we do not contend—nor have we ever—that the Commission must *raise* contract prices over the locked-in period in order to bring group revenues up to group revenue needs. Our position has consistently been that for such portions of the locked-in period in which there is an area revenue deficiency, the Commission cannot shift from a group to an individual contract basis and compound the deficit by the imposition of refunds. At the least, the Commission cannot impose refunds in the absence of a supportable finding that group revenues exceeded group revenue requirements during some portion of the locked-in period. As the Commission gave no consideration to that question, and made no finding in that regard, the court below correctly remanded to require completion of that administrative task.

Petitioners' attack upon the decision below, to a substantial extent, assumes the answer to the question in issue. They assume to be *per se* unlawful each increased rate in excess of the Commission's ceiling. From this premise they argue that the court's conclusion is incompatible with consumer interests and is at odds with § 4(e) of the Act.

At the outset, it is appropriate to put in focus the Commission's area method goal when, in *Second Phillips* and the accompanying Statement of General Policy No. 61-1 (24 FPC 818), the Commission decided to forego individual company rate regulation. That goal, as quoted by this Court in *Second Phillips,* was

"'the determination of fair prices for gas based on reasonable financial requirements of the industry' for each of the various producing areas of the country", 373 U.S. at 299. Thus, substitution of the area method contemplated that the entire producing industry in each area would be substituted for the individual company as the appropriate regulated unit or entity whose financial requirements were to be satisfied by fair prices determined in area proceedings. This goal necessarily contemplates that rate reductions and refunds, which are but integral parts of the determination of reasonable rates, be ascertained on the basis of the financial needs and the actual revenues of that same regulated unit. However, by reverting to individual contract increases as the sole criterion for refunds, the Commission departed from its own concept of the area method; and it urges this Court to affirm an admixtured concept which destroys the foundation upon which the area method rests. The area method must be applied consistently.

Petitioners' argument that consumers will pay excessive rates under the court's treatment of refunds is without basis in fact as to test year revenues and revenue needs of area producers. Consumers are charged with the pipelines' aggregate payments to area producers as a group. On a unit basis, what consumers pay producers is the per Mcf weighted average purchased gas cost to the pipeline. The Commission's "rolled in" rate approach requires that consumer rates reflect the aggregate pipeline purchased gas costs, not incremental costs.[53] Therefore, unless

[53] As noted by the Commission at page 83 of its Brief, ". . . the Commission sets pipeline rates to cover the individual [pipeline] company's costs, including the cost of the gas it buys."

such aggregate costs to the pipelines exceed aggregate revenue requirements of area producers for the related volumes, or, stated on a unit basis, unless the pipelines' average unit purchased gas cost exceeds area producers' average unit revenue requirements for the related volumes, consumers cannot possibly incur excessive charges because of producer rates.

On the basis of test year data it is clear that, even before taking account of the reductions to area producers' revenue by virtue of deductions for sub-quality gas, and before considering the refunds which the Commission ordered, consumers of Permian gas are not subjected to excessive producer rates for that gas, but rather are reciving a bargain.

The Commission determined the average unit revenue requirement to be 14.5 cents for flowing gas in the Texas portion of the Permian Basin.[54] At page 4 of the brief of California Distributors it is shown from the record (Exh. 81, R. 179e) that for the test year 1960 the average unit purchase price paid by El Paso Natural Gas Company for Permian Basin gas was 13.8 cents per Mcf. As heretofore noted, this 13.8 cent price is *before* any producer deductions for quality deficiencies, and before deducting refunds previously ordered by the Commission in earlier cases.[55] The Commission's brief herein shows that of the three

[54] For the New Mexico portion the figure is 13.5¢ *plus* State and local taxes which brings the New Mexico unit requirement in line with that of Texas.

[55] The 13.8 cent price also does not take into account the fact that subsequent to 1960 producers have made substantial refunds to El Paso by virtue of the Commission's orders in Dockets RI61-515, 29 FPC 498, 851, G-11217, 31 FPC 774, and G-16117, 35 FPC 285. Thus the 13.8 cent figure is substantially inflated.

interstate pipelines purchasing Permian gas, El Paso pays the highest price and that:

> ". . . most of the refunds due under the Commission's order result from payments made by El Paso Natural Gas Company. (Footnote omitted) Under the ruling below, El Paso's customers, who are located in California, Arizona, New Mexico and Texas, would be denied redress solely because some producers had voluntarily accepted lower payments from another pipeline [Northern Natural], which serves the Midwest." (FPC Br., pp. 97-98).[56]

It is therefore apparent that, even if we look solely to the pipeline having the highest purchased gas costs in Permian Basin, and even before adjusting those purchased gas costs downward for deductions for quality deficiencies and refunds heretofore made, consumers of Permian test year volumes received a bargain, having received that gas at a cost to them substantially below the cost to the producers for making that gas available, as found by the Commission.

On an overall dollar cost-revenue basis the record reflects the following for flowing gas for the test year 1960:

Permian producers test year aggregate costs .....$123.9 million[57]
Permian producers test year aggregate revenues ..$109.5 million[58]

These total dollar figures likewise do not take into account deductions for quality deficiencies and for amounts previously refunded by Permian producers subsequent to 1960. The record thus establishes that consumers paid to producers about $14.4 million less

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[56] This artificial division of producers for revenue comparisons is strangely inconsistent with the complete averaging approach for costing purposes.

[57] Exh. 175, Sch. 1, R. 538e.

[58] Exh. 118, Sch. 3, R. 291e.

for Permian gas than the producers' revenue requirements for that gas as found by the Commission.

We do not stress the foregoing revenue-revenue requirements relationship as establishing that on proper review on remand the Commission may not find that refunds are proper for some portions of the locked-in period. It may be that, on a proper evaluation of these relationships throughout the locked-in periods, some annual periods will reflect that refunds may properly be imposed, and the court below left that approach open for the Commission on remand. But the foregoing demonstrates that, at least for the test year, the imposition of refunds is not justifiable and not required for consumer protection. At the very least, the above revenue-revenue requirement analysis demonstrates the impropriety of the Commission's across-the-board refund order on the mere premise that some individual increases exceeded its ceiling rates, and the propriety of the court's remand to require an analysis of the interests of both consumers and producers as a condition to refunds.

An essential ingredient of petitioners' argument is the assumption that all rates above the Commission-determined average area cost level are *per se* unlawful. This assumption is erroneous, finds no support in the record, and is contrary to the decision of this Court in *Second Phillips.* Petitioners' argument is contrary to the decision of this Court in *Second Phillips* which affirmed the Commission's termination of its investigation of Phillips' rates without reducing as unlawful all of Phillips' increases above the 12.16¢ per Mcf average cost of service which the Commission found, and without requiring refunds of all amounts collected at rates above that cost level. The petitioners' argument here is the same argument made by the States of

Wisconsin and New York in *Second Phillips*. It was there properly rejected by the Commission and this Court (373 U.S. 304-307), and it should be rejected here.

As in *Second Phillips*, the Commission did not make any findings here that producer rates above the average cost level are unduly discriminatory or unduly preferential. In *Second Phillips* this Court and the Commission rejected arguments that any rate above the average cost level is thereby unjust and unreasonable and rate reductions and refunds must be ordered, recognizing that rates may properly be reduced and refunds imposed in only the amount necessary to reduce the overall revenue level to the financial requirements level. Consumer protection does not require more. That is all the court below required to be done here.

The sole issue in the consolidated § 4(e) proceedings is whether refunds should be imposed for all or some portion of the locked-in period,[59] thus putting the refund issue here in the same posture as it was in *Second Phillips*. Phillips' rates involved in its § 4(e) proceedings ranged from 5½ cents to 17 cents per Mcf (see 24 FPC at 608); hence some of Phillips' individual rate increases were in excess of its average test year unit revenue requirement. On application for rehearing in *Second Phillips*, this circumstance was urged to the Commission as demonstrating that it erred in terminating Phillips' § 4(e) dockets. On rehearing the Commission answered by saying (24 FPC at 1009):

> "The basis of our decision to terminate the dozen Section 4(e) dockets was that the rates filed in those dockets produced less revenues than the cost of service determined in our opinion. *The fact*

[59] The Commission has recognized this to be so (R. 1119d-1120d).

> *that some of these rates are in excess of the average cost of service determined by us is immaterial.* Phillips' rates would normally vary greatly because the sales are made at widely separated points and under different conditions, and there is nothing to show that these rates are discriminatory or preferential."

When *Second Phillips* reached this Court, the fact that some of Phillips' increased rates exceeded its average cost of service was again specifically urged as a ground for reversing the Commission's termination of Phillips' § 4(e) proceedings. In answer to this contention, the Court concluded (373 U.S. at 306):

> "Having decided on the basis of substantial evidence that the increases did not bring revenues up to cost of service, the Commission properly concluded, on the only matter before it with respect to these dockets, *that no refund obligation could be imposed.*"

It is therefore submitted that, on principle, *Second Phillips* is in parallel to this case and that the court below correctly concluded that the doctrine of that case controls here on the refund issue.[60]

Petitioners attempt to distinguish *Second Phillips* on the ground that the Commission there made no spe-

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[60] The California petitioners assert that "*Second Phillips* is a revenue deficiency case, where the standard used was the comparison, or balancing, of jurisdictional revenues and jurisdictional costs" (CPUC Br., p. 52). We agree fully, as did the court below. However, California further contends: "In the instant area rate case, however, we are not dealing with revenue deficiencies for past periods" (Br., p. 53). We disagree, as did the court below (XII R. 88-89). So did the Commission when, on rehearing, it made clear that the sole issue with respect to the § 4(e) proceedings consolidated herein, as well as those unconsolidated, was whether refunds were in order (R. 1119d-1120d). Under *Second Phillips* that depends upon whether there was an excess of revenues to the regulated entity during the locked-in period.

cific prescription of future just and reasonable rates for Phillips, foregoing that task and dismissing the § 5(a) proceeding in light of area ratemaking. But the attempted distinction actually defeats itself. If, as petitioners contend, every increase which exceeds the average cost level must be reduced with accompanying refunds, notwithstanding an overall revenue deficiency, a just and reasonable finding would have been mandatory before the § 4(e) increases in excess of Phillips' average cost-of-service could have been approved. The fact that this Court there approved the termination of the refund requirement in the absence of such a determination of just and reasonable rates demonstrates conclusively that the obligation to refund is related to total revenue requirements rather than to individual rates. *Second Phillips* is therefore controlling as to refund obligations, whether or not just and reasonable rates are established for the future.

Based upon the false assumption that all rates above the average cost level are automatically unlawful *per se*, petitioners urge that the decision below must be reversed because it permits producers to retain revenues at "unlawful" rates and thus retain "illegal gains" contrary to *Federal Power Commission* v. *Tennessee Gas Transmission Co.*, 371 U.S. 145 (1962). Even if petitioners' basic assumption were not unfounded, as we submit it is, their argument misconceives and misapplies this Court's decision in *Tennessee Gas* and misconceives the decision below.[61] The

[61] We find it anomalous that its Permian order is the Commission's fulfillment of its intention to provide "for prices for gas based on reasonable financial requirements of the industry" and at the same time, it bases its refund requirement on *Tennessee Gas*, a case involving an interim refund determination of an individual pipeline company.

decision below holds merely that: (1) in fixing area rates the Commission should not order rate reductions unless its order is supported by findings that, for the Permian producers as a group, the test year revenue level exceeded the revenue requirement determined by the Commission; and (2) rate reductions and refunds should be ordered only to the extent necessary to reduce the test year revenue level to the revenue requirement level. That holding is not contrary to *Tennessee Gas* and is required by *Second Phillips.*

Tennessee Gas is inapplicable for the following reasons:

(1) Both *Tennessee Gas* and *Second Phillips* were decided at the same term of court with *Second Phillips* coming a few months after *Tennessee Gas.* We find it difficult to believe that the Court would have decided *Second Phillips* as it did on the refund issue if a few months prior thereto it had held, or intended to hold, in *Tennessee Gas,* that, as petitioners here urge, refunds should be imposed on an individual contract basis even for those periods in which there is a revenue deficiency to the regulated entity.

(2) In the instant case, unlike *Tennessee Gas,* the Commission has not made, and on the record could not have made, a finding of excessive earnings by virtue of the Permian group's increased rates. Hence the finding of overall excessiveness of revenues made in *Tennessee Gas* as a prerequisite to the holding there, could not be made here, just as it could not have been made in *Second Phillips.*

(3) The question in *Tennessee Gas* was whether in its zone rate system that company would be permitted

to offset deficient rates in *one of its zones* by excessive rates in *other zones.* In this context the Court stated that "upon a finding of excessiveness" (371 U.S. at 152-153), the Commission can make "adjustments in the rate detail of the company's filing" (*ibid.*). The Court indicated that, where a company has different rates by zones and its rates in one zone are found to be too low, while rates to customers in another zone are found excessive and this finding of excessiveness is not challenged, the company's undercharge in one zone cannot be recouped by charging the unchallenged excessive rates in another zone.

No such issue is involved here. There is but one "zone" involved, *i.e.,* the Permian Basin area. The Commission has rejected all proposals that rate differentials be prescribed based upon allocations of costs to individual sales or classes of sales.[62] It has not been urged, and no findings have been made, that any of the producer contract rates are unduly discriminatory or unduly preferential. As between sellers and consumers of Permian gas, no *Tennessee Gas* case controversy exists as to whether any party should be required to bear risks that proposed rate differentials or classifications will be found discriminatory and thus result in certain consumers or classes of consumers paying rates in excess of just and reasonable rates. Under the decision below, no possibility exists that certain classes of consumers will be required to pay

[62] The rate differential between "flowing gas" and "new gas" is not based upon allocation of costs between different zones of service, but upon separate costing of pre-1961 gas and gas sold beginning January 1, 1961.

excessive or illegal rates.[63] As has been shown, producer prices are reflected in consumer rates on a weighted average basis, not on an individual sales basis. Thus, the possibility of consumer injury, or the chance of consumers in one rate zone paying excessive rates in order to compensate for undercharges to consumers in another zone, which factors governed in *Tennessee Gas,* are not present here.[64]

Some petitioners urge that the conclusion of the court below would deprive consumers of the protection of § 4(e).[65] As has been demonstrated *supra,* the court's conclusion on refunds will amply protect consumers, thus fully implementing § 4(e)'s objective

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[63] We have shown, *supra,* p. 74, that while El Paso's rates paid producers may be higher than those paid by Northern Natural, the rates paid in the one "zone," at issue here, by El Paso are not excessive, and there has been no finding, nor could one have properly been made, that the rates to El Paso are unduly discriminatory or unduly preferential.

[64] An additional circumstance is the difference between producer and pipeline rate schedules. After the interim rate order, Tennessee could file for rate increases in all or some of its zones as it is permitted to do by the Act and its service agreement. *United Gas Pipe Line Co.* v. *Memphis Light, Gas & Water Div.,* 358 U.S. 103 (1958). This right could alleviate any interim revenue deficiency. Producers have no such remedy. Producers are initially met by the bar to rate increases by the moratorium imposed in paragraphs (H) and (K) of the Commission's order (R. 694d, 698d). Additionally, unlike *Tennessee,* producers are precluded from filing increases where their contracts specify lower prices. In any event, producers could not secure even prospective relief from their revenue deficiency until completion of a new area rate proceeding at some remote date. There is, therefore, no effective means for producers to alleviate revenue deficiencies under the Commission's order while Tennessee had available such means.

[65] CPUC Br., pp. 50-51; PG&E Br., p. 33.

from the consumer standpoint. In contrast, the Commission's conclusion would essentially deprive producers of the benefits which § 4 was designed to confer upon them. In *Memphis,* in interpreting § 4 of the Act, the Court stated (358 U.S. at 113):

> "Business reality demands that natural gas companies should not be precluded by law from increasing the prices of their product whenever that is the economically necessary means of *keeping the intake and outgo of their revenues in proper balance* . . ."

Section 4 procedures are thus recognized as affording natural gas companies the means to balance revenue intake and outgo. The Commission's refund order would impair the vitality of § 4 by requiring refunds without reference to whether producers' revenue intake and outgo were in approximate balance. The statutory right to file for increases to accomplish such balance would thereby be rendered meaningless.

The Examiner recognized the injustice of the refund approach which the Commission later adopted. He concluded that refunds were appropriate only if the aggregate revenues of area producers exceeded their aggregate costs, saying (R. 267d):

> "The rationale for this method [of determining refunds] is that in the first instance refunds should be determined on an area basis, the test being whether producers in the area have collected, overall, excess revenues . . ."

The Commission rejected the Examiner's method on the grounds: (1) that it would result in inequities

among wholesale pipeline customers; (2) that one producer who might have collected "excessive" amounts should not be relieved of refund obligation because another producer collected too little; and (3) administrative difficulty. Petitioners stress the first two grounds here.

We have demonstrated *supra* that El Paso (whose purchased gas costs in Permian were higher than any other pipeline purchaser therein for the test year 1960) had an average unit purchased gas cost below the unit revenue requirement of Permian producers. Thus, the fact is that all pipeline purchasers, El Paso included, have received Permian gas at bargain prices.

The Commission argues in its brief that El Paso's customers should not be charged with "excessive payments" because Northern Natural's rates in Permian were lower than El Paso's (FPC Br., pp. 97-98). Aside from the fact that, as we have heretofore shown, El Paso did not make "excessive payments", petitioners' argument actually rests upon the assumption that producers' rates to El Paso are unduly discriminatory or unduly preferential. But the underlying assumption is false. The Commission made no finding of undue discrimination or undue preference in any of the Permian producers' rates. See Opinion No. 468 (R. 687d-688d), especially finding (8) (R. 688d). Rather, it is clear that the Commission adopted the Examiner's conclusion that none of the rates of Permian producers was unduly discriminatory or unduly preferential (R. 267d-268d). And the nature of producers' sales and the circumstances attending them preclude a finding of undue discrimination or preference. This is ex-

emplified by this Court's observation in *Second Phillips* (373 U.S. at 306):

> "... Phillips' rates would normally vary greatly because sales were made at widely separated points and under different conditions. . ."[66]

In an area proceeding it is to be expected that, because of the large number of sales involved and the different conditions and circumstances attending such a wide range of sales, rates will vary. It does not follow, however, that rates which happen to be higher than others are thereby either unduly discriminatory or unduly preferential.

As to the Commission's observation that if one producer has collected excessive amounts he should not be relieved from refunds because another producer collected too little (R. 673d), this too is at odds with the fact that the Commission made no finding that any producer's rates were unduly discriminatory or unduly preferential. Moreover, the Commission did not consider the revenues collected by individual producers, any more than it considered the costs of individual producers. To have done so would be contrary to the concept of area ratemaking. Obviously, the Commission, having refused to determine the revenue requirements of individual producers, could not conclude that any individual producer had collected excessive

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[66] In its brief to this Court in *Second Phillips* the Commission argued (p. 53):

> "Absent a showing that the gas sold under the various rate schedules is produced under similar conditions, is of similar quality, and is sold in similar markets in similar quantities under contracts negotiated at roughly the same time, a claim of discrimination based solely on price differences is wholly insubstantial."

amounts merely because the amounts collected by some producers might have exceeded the average revenue requirement of the group. There is, therefore, no basis for a conclusion that any individual producer has collected excessive amounts, and there can properly be no such conclusion unless revenue requirements of that producer are separately determined, which, of course, would defeat area ratemaking.

The Commission also cites "administrative difficulties" as an obstacle to equating industry revenue with industry expenditures (R. 673d). There is no sound basis for this assertion. It is a simple matter of calculation to ascertain whether industry revenues as a group were more or less than group costs as found by the Commission. The Commission found no administrative difficulty in ascertaining group costs. The revenue item, for which there is record evidence sponsored by the Commission's staff, is a matter of more simplicity. Moreover, unnamed administrative difficulties constitute insufficient reason to confiscate the property of producers who obviously already have a revenue deficiency.[67]

In *Second Phillips* neither the Commission nor this Court would agree with those who urged that the regulated enterprise should make refunds on an individual contract basis despite the fact that aggregate revenues

[67] The Commission, in referring to the Examiner's conclusion on refunds, appears to have felt that to equate flowing gas revenues and expenditures as "to each category of sales" (R. 673d) would cause administrative difficulties. The Examiner, it is true, had recommended different rates for categories of flowing gas (*i.e.*, a different rate for casinghead gas than for flowing gas-well gas and residue gas). The Commission, however, found a single price for *all* flowing gas, hence eliminating whatever complexities the Examiner's approach would have posed in that regard.

were less than aggregate costs. That same principle applies here. The sole factual but immaterial difference is that in *Second Phillips* the regulated enterprise consisted of the nationwide gas operations of a single company. The regulated entity here consists of a single group of enterprises in one geographical area. The essential point is that, no matter what the composition of the regulated entity, the entirety of its revenues and revenue needs must overbalance in favor of revenues before refunds may lawfully be imposed as to any of the individual contracts of the entity. Failing this, the regulated entity can never recover its legitimate capital needs. The Court of Appeals therefore correctly remanded for determination of the revenue balance by the Commission. The court's conclusion should be affirmed.

B. The Question of the Commission's Authority To Order Refunds Below the "Last Firm Rate" Is Not Before the Court.

CPUC, *et al.*, urge the Court to resolve whether the Commission has authority to impose refunds below the "last firm rate."[68] No other petitioner raises this question.

The question is not properly before the Court as it was not decided by the Commission. Rather, the Commission specifically reserved this question for its future decision. In applications for rehearing of Opinion 468, certain parties did raise this question, being uncertain as to whether the Commission had actually

[68] By "last firm rate" is meant the last rate in effect pursuant to a permanent certificate not subject to any refund obligation (XII R. 58). Some petitioners refer to this rate as the "last clean rate."

dealt with it in Opinion 468. In its opinion on rehearing (Opinion 468-A), the Commission declined to decide the question, saying (R. 1117d-1118d):

> "With this contention [that it had no authority to order refunds below last firm rate] we need not deal at this time, since no such situation has been presented as resulting from our order herein. It will be time enough to deal with this issue when and if it is established that any refunds below the last clean rate are required."

In its brief in the court below the Commission argued that the question of its authority to order refunds below the last firm rate "is not properly before this court."[69] After quoting the Commission's language from Opinion 468-A leaving this issue open for future decision, the Commission brief continued:[70]

> "In view of the specific deferral of this problem until it is presented with respect to a specific order for refunds and since no refunds are required to be made until further order of the Commission, any consideration of this argument prior to the expression of the Commission's views is unnecessary and premature."

Based on this assurance from the Commission, the court below did not undertake to resolve this issue (XII R. 58), and it is not properly before the Court nor ripe for consideration.[71]

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[69] Brief for Respondent Federal Power Commission in *Skelly Oil Co., et al. v. Federal Power Commission*, Nos. 8385, *et al.*, 10th Cir., p. 100.

[70] *Ibid*, pp. 101-102.

[71] Moreover, neither CPUC, *et al.* nor any other petitioner presented this question in its petition for certiorari.

IV. THE COMMISSION'S COST COMPUTATIONS DO NOT REQUIRE REVIEW IN THE PRESENT POSTURE OF THE CASE AND ARE ANYTHING BUT "GENEROUS."

A. Detailed Review of the Commission's Costing Methods and Data Sources Utilized Is Not Required.

The Commission urges *de novo* review and affirmance of certain of its highly complex and technical joint cost allocation methods (FPC Br., pp. 116-140).[72] The lower court did not reverse the Commission's finding with respect to these issues, and they are not raised by any of the petitions for certiorari filed by the Commission and its supporting petitioners.

The holding in *Chicago & N. W. R. Co.* v. *Atchison, T. & S. F. R. Co.*, 387 U.S. 326 (1967) provides no basis or requirement for this Court's *de novo* review of these

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[72] These include:

(1) The computation of successful gas-well drilling costs (pp. 116-18).

(2) The proper allocation of lease acquisition costs between oil and gas (pp. 118-19).

(3) The propriety of utilizing the modified Btu method for allocating joint exploration and development costs in costing old gas-well gas (pp. 120-127).

(4) The propriety of utilizing the relative cost method to allocate joint production costs of old gas-well gas (pp. 127-33).

(5) The inclusion of non-salable carbon dioxide volumes in the denominator utilized to compute an average unit cost of gas (pp. 133-36).

(6) The propriety of including reinjected gas volumes in the denominator utilized for deriving an average unit cost of gas (p. 136).

(7) The proper determination of allocating overhead expenses (pp. 136-37).

(8) The failure to include an allowance for federal income tax (pp. 137-39).

(9) The adequacy of the Commission's working capital allowance (pp. 139-40).

complex and highly technical matters. In the *Atchison* case, the lower court specifically reversed the agency's cost-of-service determinations and remanded for over 300 separate individual cost-of-service determinations.

Our failure to respond directly to the Commission's detailed arguments thus should not be interpreted as reflecting agreement with the Commission in this area of the case.[73] No response is required as to matters which the Commission did not and could not bring before this Court.

The brief *amicus curiae* of the Associated Gas Distributors Group (p. 12) quite properly recognizes that circumstances peculiar to Permian should not result in the establishment of precedents which would "prejudice a decision in other cases where different circumstances prevail." The Commission's brief at another point correctly observes that "Doubtless, cost data can be improved and refined as the regulation of producers matures . . ." (FPC Br., p. 32). The door therefore must be left open in future proceedings for new data, refinements in the costing methodology, changed circumstances and differences in the geographic area. In its opinion in the instant case, the Commission expressly stated that the method of new gas costing "should not be construed as necessarily constituting the final solution of this intricate problem," and that other methods of cost estimation would be given further consideration in succeeding cases. (R. 576d) The future should not be confused by premature considerations of matters which the Commission has not properly brought before this Court.

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[73] In almost every instance the Commission selected the allocation method which yielded the lowest gas cost.

B. The Commission's Cost Studies Are Anything But "Generous."

CPUC (Br., pp. 30-37), California Distributors (Br., pp. 15-20) and City of Los Angeles (Br., pp. 15-17) seek to excuse the Commission's failure to design rates sufficient to recover industry costs on the grounds that the Commission's cost determinations were "generous." Not only is such argument and approach to ratemaking without merit, but also there is no record basis for the contention that the "cost" determined by the Commission included some element over and above the minimum just and reasonable level.

The argument that the Commission's 4.08¢ old gas exploration allowance exceeds the exploration cost associated with oil-well gas is entirely invalid. Under the Commission's costing methods, exploration costs applicable to both oil well and gas well gas are treated as a current expense item to be recouped from test year sales, with no return allowed thereon. (R. 641d) Under this approach, each Mcf sold in the test year must recover the full 4.08¢ exploration allowance if the total dollars of exploration expense incurred by the industry in the test year are to be recovered.[74] The exploration costs utilized in the Commission's cost studies do not represent the costs incurred in prior years to find gas reserves produced in the test year, as the California representatives erroneously contend.

It is undisputed that exploration costs are a necessary incident to the business of finding and producing gas. Unless current withdrawals are replaced by new discoveries, the nation's inventory of gas reserves would

[74] In fact, the Commission's allocation methods assign 4.618¢ per Mcf of test year exploration expense to oil-well gas (R. 824d, col. 13, line 2).

soon be liquidated. The issue here is not confiscation, as argued by the California Distributors (Br. p. 16), and there is no question but that a rate which is just and reasonable should provide for the recovery of exploration and development costs. In *Phillips Petroleum Company,* 24 FPC 537, 555 (1960), the Commission expressly held, "There is no dispute as to the necessity for including an allowance for such costs [exploration and development] in Phillips' cost of service . .".

The California Distributors' argument (Br., pp. 17-18) that the allowance for new reserves in excess of volume produced in the test year represents an extra element of generosity is equally spurious. The Commission's new gas cost study computed the unit cost of finding the gas reserves *added* in the test year. Since the industry's annual findings of new reserves had exceeded the gas produced, the denominator of new reserves additions used by the Commission in computing the average unit cost of new gas was somewhat larger than the production volumes denominator utilized by the Commission in its old gas cost study. By treating exploration costs in its new gas cost study as an expense item to be recouped from the sale of current production, the Commission was required to convert its denominator from a reserve addition to a test year production volume basis. (R. 582d) Accordingly, the Commission's 1.11¢ adjustment for exploration in excess of production in no way results in the industry recovering an amount greater than its actual exploration outlays for the reserves added in the test year (R. 578d, 582d-584d).

CPUC seeks to create an impression of "generosity" by comparing the Commission's cost determinations with those presented by CPUC. (CPUC Br., p. 32)

The Commission, however, adopted the Examiner's finding which totally rejected the presentation of CPUC witness John J. Doran:

> "Doran's reliance on Staff's allocated data is so great that his results are too far removed from an economic cost determination for new gas-well gas to be acceptable." (R. 272d)

It should also be noted that the cost comparisons which CPUC seeks to draw (Br., p. 32) are not comparable since a 9½ percent rate of return is used in the California computations versus the 12 percent purportedly allowed by the Commission, and we have shown the actual Commission rate to be lower and less than adequate. CPUC's difference in results would largely disappear if a 12 percent return were substituted in its computations. CPUC relies upon the Commission's use of a 12 percent return as justification for the failure to consider costs incurred by producers in compressing and treating gas to bring it up to pipeline quality (Br., pp. 44-45). They cannot have it both ways. Moreover, the computed cost of casinghead gas is so dependent upon arbitrary joint cost allocations that any comparison of the cost estimates made by the various parties is not meaningful. In rejecting the various *casinghead gas* cost studies presented, the Commission adopted the analysis of the Examiner who found *only* gas-well gas costs reliable:

> "It is possible by using various types of allocations of composite total joint costs to arrive at a set of numbers and label them costs—or even 'equitable costs.' *But these results have little meaning in the circumstances of this case* because they are the end results of a series of allocations piled high on layers of other allocations, each of

which involves numerous assumptions, involved calculations, and alternatives where the *reasons for preference are often tenuous and the* differences in results can be substantial." (R. 341d)

CPUC's argument that the Commission's cost of old or flowing gas is overstated by the failure to apply a plant liquid credit (Br., pp. 35-37) is equally without merit. A liquid credit was utilized in the Commission's new gas cost computation because the costing method utilized was based on a crediting of minor or by-product revenues against total joint costs rather than an *allocation* of joint costs between products. The method used by the Commission in costing old gas required the *allocation* of joint cost and is entirely inconsistent with revenue crediting. It would be grossly improper to reduce the Commission's cost of old gas by a plant liquid credit when the Commission has not included in its old gas cost the investment by producers in the gathering and processing facilities which are required for the recovery of such liquids. CPUC's argument thus involves a gross mismatching of costs and revenues.

V. THE DECISION BELOW IS CORRECT AS TO "QUALITY STANDARDS" USED IN RATE DESIGN.

A. The Commission Failed To Provide Respondents With Adequate Notice Regarding the Establishment of Minimum Quality Standards.

No rate design testimony was presented in this proceeding with respect to detailed quality standards to be used in the establishment of adjustments to the area ceiling to reflect quality differentials.[75]

[75] The Examiner rejected such a rate design when proposed for the first time on brief by the Commission Staff on the grounds that it was not supported by record evidence. (R. 262d)

In the lower court we excepted to the Commission's adoption of a rate design providing for an elaborate system of quality premiums and deductions without first giving the parties notice that it had such a rate design under consideration. The lower court did not reach this question since its remand contemplated a further Commission consideration of the quality adjustment issues in the case, and on remand the parties would have adequate notice and opportunity to present their positions. (XII R. 52) The Commission here seeks to justify its violation of procedural due process (FPC Br., p. 154).

The first action taken by the Commission with respect to establishment of minimum quality standards was *outside* this proceeding in its Notice of Proposed Rulemaking in Docket No. R-200 issued May 22, 1961 (18 CFR §§ 2.6 and 2.61). The Commission there proposed certain standards for "pipeline quality" gas including a proportional adjustment for Btu value below 1000 per cubic foot, for excess water content, for excess sulphur content, for pressure deficiencies, and for other conditions.

On July 26, 1962 a number of producers filed a motion requesting that if the Commission were going to consider the establishment of quality standards in Docket No. R-200, then such matters should be consolidated in the Permian proceeding in order that evidence relating thereto could be presented, cross-examined and rebutted. (R. 69d-73d) The Commission denied this motion, and respondents accordingly did not introduce evidence on gas quality in relation to area pricing. Other parties to the proceeding, apparently placing a similar interpretation on the Commission's

action, also failed to present evidence on this subject. Accordingly, the Examiner found:

> "It is extremely difficult in any case, *and probably impossible on this record, to establish a complete set of differentials* for the various value and quality characteristics of gas. . . . The CPUC advocates using the differentials proposed in the Commission's Notice of Proposed Rulemaking in Docket No. R-200, but there is no basis in this record for adopting them. *Staff virtually abandons efforts at quality differentials,* and its price structure permits practically all gas of the same type to sell at the same ceiling regardless of its quality and value. . . ." (R. 249d-250d.)

Commission counsel's *post hoc* argument (FPC Br., p. 155) that the Commission's order of August 2, 1961 (issued almost one year *prior* to respondents' motion requesting consolidation of the quality issues in Docket No. R-200) gave adequate notice to the parties avails nothing.[76] That preliminary procedural order provided only for the collection of certain general categories of data but expressly provided "These data shall not be incorporated in the record in these proceedings pending further order of the Commission herein." (R. 40d) Such a collecting of general data at the very outset of an admittedly experimental proceeding could not constitute notice that the rate design adopted by the Commission four years later would contain an elaborate system of premiums and deductions from base area rates to reflect quality differentials. The Administrative Procedure Act specifically provides that persons entitled to notice of an agency hearing shall

[76] Such order is not referred to by the Commission in its Opinion or in the brief of Commission counsel filed in the court below.

be timely informed of the matters of fact and law involved. 5 U.S.C. §§ 554, 557.

B. The Commission's Quality Standards as Prescribed Are Not Supported by Proper Findings and Substantial Evidence.

The question of reasonableness of the minimum quality standards adopted by the Commission was not reached by the lower court in view of its remand of the rate of return and rate design issues. The contention of the Commission and its supporters that the lower court's remand was unwarranted, however, seeks to support the reasonableness of and the adequacy of evidentiary support for the specific quality standards adopted by the Commission.

The Commission concedes that "appropriate price adjustments for each sale could not be fixed by it on the basis of the present record." (FPC Br., p. 151) It argues, however, that the record does permit establishing the pipeline standards from which such adjustments would be made. Such standards cannot be considered in a vacuum and established without an analysis of their impact upon industry revenue requirements. Moreover, the particular standards adopted by the Commission were substantially in excess of the pipeline standards for the area and totally in conflict with the record evidence available to the Commission on this subject. (R. 911d-919d)

The court below noted that under the Commission's standards approximately 90 percent of the gas presently flowing to interstate pipelines in the Permian Basin was not of "pipeline quality." The Commission error is serious, and the substantial downward price adjustments resulting therefrom contribute to the revenue deficiency imposed upon the producing industry in the Permian Basin.

The Commission's cost of service related only to the general mixture of gas as it is produced, without regard to its quality. There is no evidence of the cost of converting such gas into "pipeline quality" gas. But in the absence of a supportable finding of the cost of converting all gas into "pipeline quality" gas, there is no basis upon which the Commission's quality deductions can stand.

The error is compounded when the downward adjustments resulting from such an extremely high set of minimum quality standards are combined with ceilings set at *average* unit cost levels. Mathematically, under such a system over 90 percent of the flowing gas volumes will be unable to recover the industry's average unit revenue requirement.

C. The Lower Court Correctly Found the Commission's 50 BTU Gap Was Unsupported.

Under the arbitrary system of quality standards established by the Commission, upward price adjustments are permitted for Btu content above 1050 per cubic foot and downward adjustments are required for Btu content below 1000. No explanation was offered by the Commission for the 50 Btu gap.[77] The Com-

[77] The separate concurring and dissenting opinion of Commissioner O'Connor, however, offers an insight as to what may have been the background of the 50 Btu gap:

> "Finally, it appears that the 50 Btu gap is important solely to the California distributors as a result of the high Btu content in the gas delivered to them at the California border. The reasons for this high standard are not known; certainly no producer participated in the negotiations leading to these sales. Rather than approve a practice of unknown origin, I would rely on the uniform contract standard for the Permian area, for the Nation, and for our proposed R-200 to set an upward adjustment from 1000 Btu's for new gas-well gas." (R. 750d)

mission specifically found that the level of Btu content "has not been a substantial problem in the Permian Basin." (R. 650d) It also noted that contracts in this area "generally contain clauses specifying that the Btu content of the gas sold shall not be less than a minimum, generally 1000 Btu's, and little gas below that level . . . has been sold in the Permian Basin." (R. 650d) After review of this matter, the lower court stated:

> "We do not understand the Commission's reasons for the gap. On remand this can be clarified." (XII R. 53)

The Commission (Br., p. 153) and CPUC (Br., p. 61) argue that this gap is justified by the fact that the average Btu content for gas in this area allegedly is 1042. Even if in fact this be the average, it provides no justification for denying producers compensation for the greater value of gas containing Btu's above the well-established standard of 1000 in this area, which is accepted in the area as "pipeline quality."

The Commission's new gas price is based upon a Continental U. S. rather than a Permian Basin area cost estimate. The average Btu content for all gas produced in the Continental U. S. is much lower than 1042.[78] Moreover, the Commission's average of 1042 for the Permian Basin area was derived by excluding carbon dioxide volumes. If such volumes were included, the weighted average is 1034 or lower. (R. 750d)[79] Equally significant is the fact that the Com-

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[78] See analysis in Examiner's Decision, *Texaco Inc., et al.*, 33 FPC 1228, 1244 (1965).

[79] Carbon dioxide volumes are included in making the quality statement determination for each contract to determine how the gas delivered thereunder measures up to the Commission's prescribed minimum standards.

mission had previously found on a fully-developed record that no accurate weighted average Btu estimate can be made.[80] Pipeline purchasers do not employ consistent methods in measuring and reporting Btu and, in many instances, no tests are made at all, but estimates are utilized. The average for any given area will change each year, as old fields are depleted and new fields are added. Current records of Btu content are frequently not kept, however, since such data are not required as long as the producer and pipeline are satisfied the contract minimum standard of 1000 for "pipeline quality" has been met.

Most of the gas flowing in the Permian Basin would fail to meet the quality standards prescribed by the Commission. (XII R. 52) The justification offered for the establishment of standards was that it is "important that our price for new gas-well gas reflect the energy content of the gas, which in reality is what the consumer is purchasing." (R. 651d) On the basis of such rationale, and considering that all of the other Commission's quality standards will result in downward adjustments to the producer, there is no justification for denying an offsetting upward adjustment to a producer who offers gas with an "energy content" in excess of 1000 Btu, the uniform contract standard for pipeline quality gas in the Permian Basin area. Just two months prior to the issuance of Opinion 468, the Commission in its Opinion No. 464 had found upward Btu adjustments from the base of 1000 to be in the public interest.

Basically, of course, the Commission's error here stems from the fact that, unlike its action with respect to other quality differentials, it attempts in its brief

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[80] *Texaco Inc., et al.*, 33 FPC 1228, 1244 (1965), FPC Opinion No. 464.

to justify Btu price adjustments from the average *actual* Btu content of gas produced in the Permian Basin, instead of from the *contract* pipeline standard for the area.[81] The Commission expressly recognized that 1000 Btu gas meets pipeline standards in the Permian Basin area. (R. 652d) If the producers had been afforded consistency of treatment, the other quality standards (*e.g.*, pressure, sulphur content, and water) would have been based upon *average actual* conditions, rather than upon contract pipeline standards.

The use of the different bases for upward and downward Btu adjustments is also discriminatory because it establishes a greater price penalty for gas below the 1000 Btu level than the reward for gas above the 1050 Btu level. Thus for example, if gas falls 50 Btu's short of the 1000 Btu level at a 14.5¢ applicable ceiling price, it is entitled to 13.775¢ per Mcf. On the other hand, if gas exceeds the 1050 Btu level by 50 Btu's under the same ceiling price, it is entitled to 15.1905¢ per Mcf.[82] It is thus seen that the penalty for falling 50 Btu's short of the 1000 Btu's per cubic foot level is .725¢ per Mcf while the reward for exceeding the 1050 Btu level by the same margin is only .6905¢ per Mcf. This result is totally illogical and without support in the record and requires reversal of the Com-

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[81] In discussing its basic approach to establishing quality differentials, the Commission stated:

> "A preliminary question is the basis upon which the quality adjustments should be applied. We think these price differences should be predicated upon differences in the quality of gas sold under particular contracts *rather than upon an averaging process.*" (R. 647d)

[82] 950 ÷ 1000 × 14.5¢ = 13.775¢; 1100 ÷ 1050 × 14.5¢ = 15.1905¢.

mission's price adjustment procedures insofar as Btu is concerned. It also demonstrates that there can be no "averaging" or "offsetting" of above and below standard Btu gas sales, even if by sheer coincidence the volumes above and below the standard were identical. This matter must be corrected on remand.

VI. THE COMMISSION'S "SAVINGS CLAUSE" OR "EXEMPTION" PROCEDURES ARE INADEQUATE.

The Commission and others attack the holding below that the Commission's "savings clause" procedure is inadequate (FPC Br., p. 64). Their arguments rest primarily upon misinterpretations of the holding and ignore importance of an adequate "savings clause" to legality of the area rate method under the Act and the Constitution.

On this issue, the decision below rests upon principles that should no longer be the subject of debate in rate regulation. The court first referred to the right of a regulated entity to be heard when it seeks to show a rate will result in confiscation if applied to it (XII R. 50), and recognized the necessity that opportunity be afforded to make such a showing initially before the ageney.[83] Comparing the Commission's order with these principles, the court condemned Commission expressions as too "vague" and noted factors appropriate for Commission guidelines, concluding (XII R. 51):

> "An adequate savings clause should contain guidelines which if followed by an aggrieved pro-

[83] The holding below thus follows *The New England Divisions* Case, 261 U.S. 184 (1923), *North Carolina* v. *United States*, 325 U.S. 507 (1945), and *King* v. *United States*, 344 U.S. 254 (1952), in which the constitutional roots of "savings clause" procedures were recognized. See also *Jordan* v. *American Eagle Fire Ins. Co.*, 169 F.2d 281 (D.C. Cir. 1948), and *Baltimore & O. R. Co.* v. *United States*, 298 U.S. 349 (1936).

ducer will permit it to be heard promptly and to have a stay of the general rate order until its claim for exemption is decided."

The Commission and other petitioners apparently do not question the holdings as to individual rights to be heard upon a claim of confiscation and, upon proper showing, to exemption from rates based on composites of group data. Their objections focus upon the language as to guidelines and stay.

As to guidelines, the Commission has been judicially reminded that, particularly when it establishes a rate regulatory procedure, it has a ". . . . duty at some stage prior to the close of proof to declare what it considered the relevant standards to be."[84] Commission experience in individual company regulation has been sufficient that the Commission can readily express, in understandable terms, what will be considered a "prima facie" showing, pending complete investigation and review. Over the years, the Commission has evolved similar "guidelines" in other rate procedures (see, *e.g.*, 18 C.F.R. §§ 154.63 and 154.94). The salutary suggestion that such guidelines be expressed for area rate exemption procedures should be welcomed, not rejected.

Beyond this, the Commission argument is prejudicial to the public interest and contradicts the stated purpose of area rate proceedings. As the Commission argued in the *Second Phillips* case, *supra,* the purpose of the area rate method is to expedite determination of just and reasonable rates by relieving the Commission of the administratively infeasible task of deciding a multitude of individual producer cases. However,

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[84] *Hill* v. *Federal Power Commission,* 335 F.2d 355, 358 (5th Cir. 1964).

the Commission argues, in effect, at numerous places in its brief that savings clause proceedings should be substituted for the remand ordered. This approach would convert the area rate method into a device for delaying indefinitely final determination of just and reasonable rates for producers.

Under the Commission's leave-everything-to-special proceedings arguments, decisions in area rate cases would become mere predicates for the very type of individual company proceedings which the area approach is intended to supplant. A savings clause is not a substitute for full and complete findings in area rate proceedings. And the Commission has a duty, prior to close of proof, to declare relevant standards. For nothing is more productive of litigation than failure to establish proper guidelines. Incomplete and ambiguous rate orders are barriers to efficiency in the administrative process, and are principally productive of infinite litigation, controversy, and delay.

As to stay, the Commission and others assert that the court has directed automatic stay for all who merely express a desire for exemption. Regardless of merit of such a practice, the court's holding cannot be so read. The court holds only that stay should be granted if the guidelines are "followed." This merely points to traditional criteria followed by federal agencies and courts in weighing motions for stay, pending hearing upon the merits of a claim for substantive rate relief.

In sum, constitutional requirements and practicalities of attempting to use group procedures and composite data dictate that such procedures be an integral part of the "area rate" method. Notice of substantive

"guidelines" and provision for stay upon proper showing are required safeguards in the Commission's duty to afford due process to individuals affected by its rate orders.

VII. THE EFFECT OF THE COMMISSION'S RATE ORDER UPON FUTURE SECTION 7 CERTIFICATE PROCEEDINGS IS NOT BEFORE THE COURT.

Ordering paragraph (C) of the Commission's order of December 23, 1960 instituting these proceedings provided for the *consolidation* of certain pending Section 4(e) and Section 7 certificate proceedings. Concurrently with the issuance of Opinion 468 prescribing just and reasonable rates under Sections 4 and 5 of the Act, the Commission issued a separate order granting permanent certificates of public convenience and necessity in the *consolidated* Section 7 proceedings. (R. 827d, *et seq.*) The initial price authorized in such certificate order was the Commission's applicable area rate for new gas. The lower court on rehearing remanded the Commission's separate certificate order on the grounds that it should be governed by the determination of the area rate on remand. (XII R. 88)

CPUC (Br., pp. 61-62) and California Distributors (Br., pp. 39-40) contend that the Commission's concurrent certificate order should be affirmed. We would not challenge the affirmance of such order if the Commission's area rate were affirmed since the certificate applicants in the consolidated Section 7 dockets were given notice that certificates would be issued on the basis of the record made in this proceeding. CPUC

and California Distributors, however, go further and ask the Court to declare as a matter of law that the Commission's area rate should also be the initial certificating price in *future* Section 7 proceedings instituted *subsequent* to the issuance of the Commission's area rate order. This issue is not properly before the Court and was not reached by either the Commission or the court below. With respect to this matter, the Commission stated:

> "We are not here treating sales to be permanently certificated *after* the effective date of this decision . . . .
>
> * * *
>
> "The problem for our immediate attention thus relates solely to gas presently being sold under *outstanding* certificates." (R. 657d)[85]

The lower court on rehearing made equally clear that it did not reach this question:

> "We do not there, and we do not here, express either approval or disapproval of the principle that an area rate established in a § 5 proceeding automatically becomes an in-line rate for a § 7 proceeding." (XII R. 88)

The area rates established in this proceeding were based upon a 1960 test year. The Section 7 statutory standard of "present or *future* public convenience and necessity" does not permit the sterile, mechanical application of a past rate determination based upon a potentially stale test year to proposed new sales. Such

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[85] A similar finding was made by the Examiner (R. 265d).

procedure would totally violate the hearing requirements expressly prescribed by Section 7 of the Act.[86]

The substantial period of time required to conduct an area rate proceeding demands that the Commission be given sufficient flexibility during the interim period between the first and second round of area proceedings to make whatever adjustments are indicated in its pricing policies applicable to new sales by changes in supply-demand conditions and industry cost levels resulting from inflation and other such factors. The more limited proceedings under Section 7 provide the logical mechanism to accomplish this objective.[87] The Commission recognized in Opinion 468 that "changing circumstances might demonstrate the need for new and substantially different rates for gas-well gas coming on the market at later periods." (R. 662d)

This matter was separately considered by the Commission in a separate case, as to which petitions are

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[86] In recognition of the possibility of changed circumstances and the statutory right of a certificate applicant to a hearing, the Commission concurrently with the issuance of its area rate opinion also issued an order to show cause covering certain Section 7 certificate applications *unconsolidated* with the area proceeding but filed *prior* to the issuance of the Commission's area rate order. (34 F.P.C. 424 (1965)) In response to such order, the show cause respondents presented evidence showing that higher initial prices were required since the more current cost evidence indicated producers were experiencing higher cost levels than those incurred in the 1960 test year. The Commission has not to date acted on these unconsolidated Section 7 certificate applications which were the subject of its show cause order.

[87] No great administrative burden would be created if consolidated proceedings were convened periodically and included all certificate applications filed during such period, which proposed initial rates in excess of the area ceiling. The basic regulatory methods and procedures of area ratemaking would not be relitigated but simply applied to current industry data.

pending in Nos. 373, *et al.*, this Term. That case involved the Commission's disposition of Section 7 certificate applications in which hearings were convened *subsequent* to the establishment of the Commission's area rate. The issue raised by CPUC and California Distributors therefore is clearly not before the Court in the instant case.

VIII. THERE IS NO ERROR AS TO INTEREST IN THE STAY ORDER ENTERED BY THE COURT OF APPEALS.

The Commission argues that when the court below stayed effectiveness of Opinion Nos. 468 and 468-A, the court erred in including in its order a clause providing, in effect, that if the orders were affirmed, interest of 4½ percent would be paid on amounts collected on and after September 1, 1965 in excess of "applicable area rates" prescribed by the Commission (FPC Br., p. 168). The court did not err in so ordering.

The Commission's argument requires reference to specifics in ordering paragraphs of Opinion No. 468. Paragraphs (A) and (B) prescribed maximum "Base Area Rates" and "standards" for deductions to compute "applicable area rates" as defined in ordering paragraph (C) (R. 688d-691d). Ordering paragraphs (D) and (N), taken together, provided that such "applicable area rates" should be effective from and after September 1, 1965, and ordering paragraph (D) further provided that amounts collected in excess of these rates would be subject to refund "plus interest at 7 percent" (R. 698d, 691d). However, collection of such amounts indefinitely was not to be permitted. Other provisions required filing of rate schedule supplements, within forty-five days, reducing rates to the "base area rates"; the filing, within ninety days, of still other statements reflecting the further deductions

for quality; and Commission acceptance of such statements where agreed upon by buyer and seller, within 60 days of filing (R. 691d-692d).

Three immediate rate reduction and refund steps thus were contemplated: (1) on or before October 15, 1965, reduction *to* the "base rate" level as of September 1, 1965; (2) prior to February 1, 1966, further reductions, as of September 1, 1965; but (3) retention of funds already collected *prior to* September 1, 1965, but to be held indefinitely by producers, with a 4½ percent interest rate on any refunds ultimately made after further orders by the Commission (R. 696d).

The Commission denied stay, pending judicial review (R. 1128d). However, after extensive pleading and argument, the court below entered its January 20, 1966 stay order.[88] That order did not stay Commission collection of refund reports, statements of quality, rate schedule supplements, or reports on Section 4(e) funds collected prior to September 1, 1965. The order did stay the effectiveness of the immediate and scheduled rate reductions contemplated by the Commission's order.

The court thereby created a fund *not* contemplated *or* covered by the Commission's orders, but collected pursuant to the order of the court, and consisting of all excess amounts, if any, collected on and after September 1, 1965, until such time as review is completed

[88] The court required written memoranda and heard oral argument as to "(1) the injury to the producers, (2) the injury to others, including the public and those intermediate between the producers and the public, and (3) what protective devices can or should be ordered to prevent such injuries in the event of either the grant or the denial of a stay." (XII R. 2).

and the stay is dissolved.[89] As to this new, distinct fund so created but held by producers, the court imposed the condition of contingent liability of 4½ percent interest—the *same* rate adopted by the Commission itself as applicable to the similar but separate fund collected, retained, and commingled, prior to September 1, 1965. The fund so collected pursuant to the order of the court thus remains subject to further court order.

Despite the separate categories of funds, the Commission now makes a strained argument that the court's order somehow "modified" a Commission order in a manner not permitted under Section 19 of the Natural Gas Act. This argument overlooks two basic facts: (1) the stay order did not embody or entail review of the merits of any Commission order;[90] and (2) the interest rate relates to a fund *not* contemplated or covered by any Commission order whatever—amounts collected during the pendency of judicial review.

The authority of the court to stay a Commission order cannot be questioned.[91] A court of appeals, "guided" by the requirements of "justice" and

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[89] The order thus applies to interest only ". . . for the period during which this order is effective." (XII R. 14).

[90] In this respect, the court of appeals correctly stated as to its order: "Nothing herein or in the stay order to be entered is intended to be any determination on the merits of any issue raised by any party to any of these proceedings." (XII R. 11).

[91] See Sections 19(b) and (c) of the Act, 15 U.S.C. 717r; *Natural Pipe Line Co. of America* v. *Federal Power Commission*, 129 F. 2d 515 (7th Cir. 1942); *Virginia Petroleum Jobbers Association* v. *Federal Power Commission*, 259 F. 2d 921 (D.C. Cir. 1958); *Scripps-Howard Radio, Inc.* v. *Federal Communications Commission*, 316 U.S. 4 (1942).

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"equity,"[92] also may prescribe conditions to operation of a stay, exercising power "inherent in the courts as a court of equity," and "exercised from time immemorial." *Russell* v. *Farley,* 105 U.S. 433, 438 (1882); see also *Inland Steel Co.* v. *United States,* 306 U.S. 153, 156 (1939). Under the Natural Gas Act, the courts thus have recognized duty and power to perform all acts required to effectuate stay orders under principles of equity and as a part of their jurisdiction under Section 19, including prescription of interest rates. See *Natural Gas Pipeline Co. of America* v. *Federal Power Commission,* 128 F. 2d 481, 484, 487 (7th Cir. 1942); *Panhandle Eastern Pipe Line Co.* v. *Federal Power Commission,* 154 F. 2d 909 (8th Cir.), *cert. den.,* 329 U.S. 761 (1946). In formulating these conditions, the court is acting independently of contents of an agency order, exercising its own judicial functions, and prescribing conditions the court deems required by its view of the equities.[93] The Tenth Circuit, as have the other circuits, thus entered its stay and prescribed required conditions, including an interest rate.

Having denied stay itself, the Commission attempts to usurp the judicial function by contending that when

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[92] *Natural Gas Pipeline Co. of America* v. *Federal Power Commission,* 129 F. 2d 515, 516 (7th Cir. 1942).

[93] As stated by the Seventh Circuit in *Natural Gas Pipeline Co. of America* v. *Federal Power Commission,* 128 F. 2d 481, 484 (1942):

> "We think it well settled that in respect to review of orders of Federal Boards and Commissions, the jurisdiction of the Circuit Court of Appeals, when granted by Congress, is original rather than appellate in character and that, being endowed with original jurisdiction, the court may by its own orders protect the rights of the parties in any manner in which any trial court of equity of general jurisdiction might do in an injunction suit."

a court so grants stay, Commission orders stayed then should control conditions of stay. This borders upon the absurd: if the Commission wished so to control conditions of stay, its power to grant stay could have been exercised; if, however, as here, it refuses, the power to grant stay and prescribe the conditions passes to the court of appeals. Neither the Act, nor necessary division of administrative and judicial functions, permits the Commission to abstain, but then interject itself as the dictator of the terms of the court of appeals' stay order—an order resting upon the court's assessment of the equities, not that of the Commission.[94]

Here, the Commission seeks to blur this distinction in functions by reference to paragraph (D) of its order, but the argument is misconceived. Neither that paragraph nor any other part of the Commission's orders dealt with funds collected pursuant to a stay pending judicial review, and that paragraph and other provisions contemplated immediate effectiveness and an interest rate applicable only to a minimal fund to be collected during the 90 to 120 days required for filings and accounting adjustments to place in effect the reduced rates effective September 1, 1965. Ordering paragraph (D), including the interest provision,

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[94] The Commission cannot attack the court's interest provision as an "abuse of discretion," and its "question presented" here is not so stated. In this respect as to a similar retained fund subject to Commission discretion, the Commission, as noted *supra*, used the same 4.5% interest rate. The Commission also made no complaint to the court below on such grounds. Moreover, the Commission should be estopped from questioning the interest rate because, preparatory to review here, the Commission itself successfully moved the court below to continue its stay pending review here. At that time, the Commission said nothing whatever to the court below concerning interest or the rate to remain in effect under the court order.

thus never went into effect because of the operation of the stay. As a result, no funds have ever been or will be collected to which ordering paragraph (D) applied or can apply, and all funds involved since September 1, 1965 have been collected pursuant to judicial stay and the terms entered with full authority by the Court of Appeals.[95]

IX. THE PRESCRIBED RATES CANNOT INDUCE ADEQUATE SUPPLY.

The decision by the Commission to base its rates in this case on average unit cost calculations has served to obscure an important public purpose of producer rate regulation: whether the rate levels prescribed will result in adequate supplies of gas. In its brief here the Commission states positively that the rates prescribed will induce adequate supplies (FPC Br., pp. 164-67). This conclusion is without foundation because, as the court below pointed out, the Commission does not know what revenues will result from the prescribed ceilings (XII R. 60), and because the Commission declined to fix any appropriate level of gas supply for the industry (R. 561-62d).

As we have earlier established, the result of the Commission's order is to force average revenues to some unknown level below the average cost. With this

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[95] The Commission cites cases such as *Pan American Petroleum Corp.* v. *Federal Power Commission*, 376 F. 2d 161 (10th Cir. 1967), which are wholly irrelevant. In these cases, the Commission imposed an interest rate. Against attacks, the courts have not reversed the Commission's exercise of discretion as to the interest rate imposed. Here, however, the Commission refused to grant stay; funds involved have not been collected pursuant to a Commission order; and the interest rate is within the court's discretion, not that of the agency.

undisputed result, the order cannot achieve the objectives which the Commission set for itself. Thus the Commission described as "vital" the continuation of a strong exploration program by producers (R. 560d) and adopted a dual pricing system to encourage such exploration (R. 564d-65d). The Commission recognized that funds to carry on such exploration are to come at least in part from revenues from old gas (R. 633d). But it belies credulity to suggest that such objectives are attainable through average revenues which are less than average costs.

The overriding importance of gas supply in the regulatory scheme has been long recognized. Justice Jackson said:

> "... if the supply is not too plentiful and the price is not a sufficient incentive to exploit it and fails to bring forth the quantity needed, the price is unwisely low, even if it does not square perfectly with somebody's idea of return on a 'rate base'." [96]

In its brief the Commission seeks to justify its decision as to the supply issue by reference to a number of extraneous considerations, many of which are outside the record, and few of which were relied on or alluded to in the opinion.

A. The Allowance for Exploration in Excess of Production Is Ineffectual as an Incentive.

The Commission argues that because it provided an allowance in its cost calculation for new gas-well gas to permit findings in excess of production (R. 583d)

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[96] *Colorado Interstate Gas Co.* v. *Federal Power Commission*, 324 U.S. 581, 612 (1945) (concurring opinion); quoted with approval by the Commission in *Phillips Petroleum Company*, 24 F.P.C. 537, 548 (1960).

that exploration should continue to yield such findings. This simple statement conceals a number of inaccuracies: (1) the allowance referred to is only a small part of the total cost calculation for new gas-well gas (XII R. 40)—the efficacy of the incentive depends on the price as a whole;[97] (2) it assumes that the national cost computation is proper for the Permian Basin area; and (3) it assumes that a continuation of past exploratory trends will result in a satisfactory supply picture.

With reference to the last two matters the Commission's argument can be tested against the facts. Without commenting on the application of a national cost calculation to the Permian Basin area, we can examine the national supply picture in terms of both the relationship of proved reserves to annual demand (production) and the trend in gas exploration. Both of these data series reflect the influence of Commission regulation since the implementation of "guide-line" and "in-line ceilings" after 1960:

RESERVES TO PRODUCTION RATIO—U.S.[98]

1960	20.1
1961	19.8
1962	19.8
1963	18.9
1964	18.2
1965	17.5
1966	16.4

[97] More importantly, this so-called "allowance" is merely a mechanical method of providing current recovery of current exploration and development outlays, a practice which the Commission rightly recognized as proper (R. 641d).

[98] For 1960, R. 151e, Part A, Col. (g) ÷ Col. (b); for subsequent years, from same source.

Although the data for the last 2 years were not available to the Commission when it issued its Permian decision, the trend was clear but ignored. The Commission said:

> "The ratio . . . will probably decline further regardless of the price of gas set by this Commission." (R. 562d)

This is a strange statement to hear from the agency whose price fixing actions effectively regulate the available supply of gas, and which also states that it agrees:

> ". . . that a strong exploration program which will discover and develop gas reserves in ample time to meet the increasing demands of [sic] gas is vital". (R. 560d)

The trend of gas exploration is far from the "strong program" endorsed by the Commission:

SUCCESSFUL GAS EXPLORATORY WELLS—U.S.[99]

1960	868	1964	556
1961	813	1965	515
1962	771	1966	574
1963	664		

The price levels fixed by the Commission in Permian offer no reason for a reversal of the trends in either category; we show later that the Commission has cut, not increased prices. The allowance for findings in excess of production as a small part of an inadequate overall price cannot operate as an incentive for gas exploration. Indeed, as noted earlier, a rate of return lower than that allowed pipelines is no "incentive" to attract capital to far riskier exploration activity. (*supra,* p. 60, fn. 40).

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[99] For 1960 and 1961, R. 569e; for later years, from same source.

B. Pipeline Prepayments Are Not Evidence of Oversupply

The Commission points to prepayments incurred by the three major pipelines in the Permian Basin for gas purchased but not taken as indicative of difficulty in reselling gas contracted to be purchased (FPC Br., p. 165).

Such balances reflect, separately for each pipeline, the timing of the pipelines' purchases of new gas supplies, the certification of the pipelines' expanded facilities, the terms of the purchase contracts, and the rate of development of the pipelines' markets relative to the development of the contracted reserves. The lack of relationship of such prepayment balances to the issue of supply is illustrated by the fact that in August, 1967 the Commission, with full knowledge of El Paso's prepayment balance, recognized El Paso's need for still more gas:

> "The record in this proceeding satisfactorily demonstrates that the area serviced by El Paso's Pacific Northwest Division has a need for and can utilize the additional imports of 200,000 Mcf per day of Canadian gas; . . . ." [100]

The Commission's supply argument based on pipeline prepayments will not bear scrutiny in light of the foregoing facts.

C. The Commission Did Not Increase New Gas Prices by Its Permian Decision.

The Commission states that its Policy Statement ceiling price was 16 cents per Mcf and that its area rate prescribed here has raised the ceiling (FPC Br., p. 166). While superficially correct, the statement is mis-

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[100] *El Paso Natural Gas Co.*, Opinion No. 526, issued August 10, 1967, Mimeo., pp. 9-10.

leading in light of regulatory practice. The Policy Statement price of 16 cents per Mcf was for pipeline quality gas, but that quality was never defined by the Commission. The practical effect was that, in the absence of opposition, the Commission would certificate sales at 16 cents per Mcf without specific inquiry into the quality of gas involved.[101]

In contrast, the area ceiling for new gas-well gas established in the Permian decision is 16.5 cents per Mcf, *but subject to quality deductions.* The Commission's own brief points out that after-the-record reports show an average quality deduction for new gas-well gas of 0.68 cents per Mcf (Br., p. 141) which would yield an average revenue realization of 15.82 cents per Mcf.

True, the Commission has established a ceiling higher than the "guideline" but, as in other contexts, the ceiling is illusory if it cannot be realized by virtue of other provisions of the Permian order. It follows that no "increase" in price can be relied on by the Commission as an incentive for new gas exploration.

D. The Post-Hearing Drilling Activities in the Permian Basin Do Not Vindicate the Commission's New Gas Price.

The Commission (FPC Br., pp. 166-67) and the California Distributors (PG&E Br., pp. 45-46) point to trade journal articles concerning increased drilling activities in the Permian Basin following issuance of the Permian decision. These articles do not, of course, constitute evidence in the proceeding and should not influence this Court's decision herein. Nevertheless,

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[101] As stated in the Commission's Annual Report: "New rate proposals by producers generally are accepted if the price is at or below the 'guideline ceiling'." (1963, p. 140)

they have been called to the Court's attention, and we must point out that they frequently contradict the thesis of the citing party.

The Commission states that the incentive to search for gas in the Permian Basin is "unabated" (FPC Br., p. 166) and the California Distributors state that most of this drilling activity has occurred after the Commission's Permian decision (PG&E Br., p. 46). The cited article disputes both points. The deep drilling activity in the Delaware Basin sector of the Permian Basin area commenced in 1961, and the first production from the post-1961 discoveries commenced in the fall of 1966—after 5 years of development work;[102] the Commission's decision in Permian was issued August 5, 1965. The first of such discoveries occurred at the Gomez Field in 1963.[103] It is therefore apparent that the Commission's Permian decision can claim no credit for such deep drilling activities. In addition, such deep drilling activities in the Permian Basin are spurred by the fact that there are few places left to seek large new gas reserves in the country; this area may be one of the nation's last hopes for big blocks of onshore gas reserves.[104]

Finally, as in the context of the reserves-production ratio, mere reference to reserves or drilling activity without consideration of the demand for gas is mean-

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[102] "Gas Reserves Zooming in the Delaware", Oil and Gas Journal, June 13, 1966, pp. 62, 65.

[103] "Gomez Field, West Texas Delaware Basin Gas Giant, Still Expanding", Oil and Gas Journal, January 9, 1967, pp. 78, 79.

[104] "Delaware Basin Score is 55", Oil and Gas Journal, March 6, 1967, p. 139.

ingless.[105] True, there has been substantial deep drilling activity and substantial reserve discoveries in the Permian Basin, both before and after the Commission's decision, but the question is, has it been enough? There are indications the demand continues to outstrip supply. It has been reported that producers could sell 8 trillion cubic feet of reserves in the area while there is not one trillion available, even for the intrastate market, which in the producer view is preferable to the interstate market.[106] Finally, the California Distributors find support for the Permian decision in the producers ease of marketing new gas supplies to interstate pipelines (PG&E Br., p. 45). Nothing is more characteristic of an inadequate supply condition than ease of marketing from the suppliers' viewpoint. This argument by the California Distributors simply will not square with the Commission's view that its decision will bring forth adequate supply.

E. The Commission's Decision Fails To Provide Supply Assurance.

California emphasizes its large consumption of natural gas and need for out-of-state supplies, most of which is supplied by Permian Basin pipelines (CPUC Br., p. 6). Such emphasis is properly taken, but in its support for the Commission's decision, California does not even speculate, much less evaluate, whether the decision will fulfill those needs. It is indeed

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[105] In contrast to the decline in the R/P ratio and in gas exploration, the demand for natural gas has exceeded all forecasts. In 1960, when the Permian proceeding was convened net production was 13 trillion cubic feet; in 1966 net production climbed to over 17.5 trillion cubic feet, an increase of 35%. (For 1960 R. 151e; later years from same source.)

[106] "Intrastate Firms Hustle for Texas Gas", Oil and Gas Journal, September 11, 1967, p. 47.

anomalous that, in this landmark decision, the overriding issue of supply adequacy is largely ignored by the Commission's supporting petitioners, and that the decision itself is absolutely devoid of findings as to what gas supply is proper or as to what gas supply will be elicited by the rates established. The Commission refers to the supply factors weighed by the examiner (FPC Br., p. 166) but does not point out that the examiner also concluded that a 17.5 year reserves-production index in 1970 was a satisfactory level for gas inventory (R. 125d). As we pointed out above, the R/P ratio fell to 16.4 at year-end 1966.

The Commission concludes its argument on gas supply by reminiscing over *Hope,* that the doors are open to a price increase if supply becomes inadequate (FPC Br., p. 167). This is obviously true, but fails to recognize the crank-up time required to make gas available to the market. We earlier referred to a five-year period for making currently developing deep production in the Permian Basin available to the market and this period has been as long as fifteen years in other instances.[107]

Under these circumstances the Commission's plea to let the future take care of itself fails to reflect the concern properly to be expected of responsible regulation.

X. CORRECTIVE COMMISSION ACTION ON REMAND IS NECESSARY TO REACH A LAWFUL RESULT.

Necessary remedial steps on remand do not entail discarding the record or long delay in issuance of lawful order. To the contrary, the Commission may promptly make findings upon evidence as to (1) the

[107] R. 70-71. The examiner also recognized this long lead time requirement, R. 133d.

group revenue requirement, and (2) maximum and minimum rates required to establish a "reasonable" over-all rate structure and a body of non-preferential, non-discriminatory specific rates to permit receipt of aggregate revenues consistent with the group revenue requirement. These steps will permit inauguration of the "area rate" system with a structure of rates resting upon known financial and economic data actually spread upon the record.

The solution is not, as the Commission's brief suggests at more than ten places, wholesale petitions for relief from area rates and "waivers" to cure widespread inequities presented by producers who are petitioners here.[108] Omissions and patent mistakes in group rate design should be corrected by removing the glaring defects in the general orders, not by placing into effect a structure of rates that will require numerous individual and class exceptions from the outset.

Clear standards, consistently and lawfully applied, will make possible a workable area rate system.[109]

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[108] The Commission concludes many of its arguments against other petitioners with statements to the effect that the problems discussed can be considered on petitions for relief and solved by waiver and the granting of exceptions. See FPC Br., pp. 16, 26, 30, 38, 64 n. 38, 65 n. 40, 96, 98, 160 162, and 163.

[109] Adherence to the principles set out by the court below and in *Hope* therefore will *not* delay decision in other pending "area rate" cases as some parties seek to show. In the three cases awaiting Commission or Examiners' decisions (Docket Nos. AR61-2, AR64-1 and AR64-2), it is recognized by most, if not all, parties that evidence already received or tendered provides an adequate basis for all required findings for design of rates consistent with the lower court's decision and *Hope*. See, *e.g.*, "Motion for Leave to File Brief Amicus Curiae and Brief Amicus Curiae on behalf of Associated Gas Distributors Group." Formal hearings in the fourth pending case (Docket No. AR67-1) will not commence until March, 1968.

The converse is presented here—mere agency assertion that its action may be labelled "fair", reliance upon materials outside the record, and prescription of unknowns. The agency process thus degenerates into a procedure under which "just and reasonable" would become a matter of subjective guess. Tilting of the "balance" between consumer and investor interest would become inevitable. The degree of error, even when error is recognized, would become unmeasurable. Aggrieved interests could not show, and a court could not order, the adjustments required to correct error and remove the imbalance.

The opinion below properly recognized the foregoing deficiencies. The necessity for remand was inescapable. Commission completion of its task is essential to the lawful and orderly development of area rate regulation.

CONCLUSION

For the foregoing reasons, the decision and remand of the court below should be affirmed.

Respectfully submitted,

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October 9, 1967

APPENDIX

1. Administrative Procedure Act of 1946, Section 4, as recodified, 80 Stat. 378 (1966), 5 U.S.C. § 554:

§ 554. Adjudications.

(a) This section applies, according to the provisions thereof, in every case of adjudication required by statute to be determined on the record after opportunity for an agency hearing, except to the extent that there is involved—

(1) a matter subject to a subsequent trial of the law and the facts de novo in a court;

(2) the selection or tenure of an employee, except a hearing examiner appointed under section 3105 of this title;

(3) proceedings in which decisions rest solely on inspections, tests, or elections;

(4) the conduct of military or foreign affairs functions;

(5) cases in which an agency is acting as an agent for a court; or

(6) the certification of worker representatives.

(b) Persons entitled to notice of an agency hearing shall be timely informed of—

(1) the time, place, and nature of the hearing;

(2) the legal authority and jurisdiction under which the hearing is to be held; and

(3) the matters of fact and law asserted.

When private persons are the moving parties, other parties to the proceeding shall give prompt notice of issues controverted in fact or law; and in other instances agencies may by rule require responsive pleading. In fixing the time

and place for hearings, due regard shall be had for the convenience and necessity of the parties or their representatives.

(c) The agency shall give all interested parties opportunity for—

(1) the submission and consideration of facts, arguments, offers of settlement, or proposals of adjustment when time, the nature of the proceeding, and the public interest permit; and

(2) to the extent that the parties are unable so to determine a controversy by consent, hearing and decision on notice and in accordance with sections 556 and 557 of this title.

(d) The employee who presides at the reception of evidence pursuant to section 556 of this title shall make the recommended decision or initial decision required by section 557 of this title, unless he becomes unavailable to the agency. Except to the extent required for the disposition of ex parte matters as authorized by law, such an employee may not—

(1) consult a person or party on a fact in issue, unless on notice and opportunity for all parties to participate; or

(2) be responsible to or subject to the supervision or direction of an employee or agent engaged in the performance of investigative or prosecuting functions for an agency.

An employee or agent engaged in the performance of investigative or prosecuting functions for an agency in a case may not, in that or a factually related case, participate or advise in the decision, recommended decision, or agency review pursuant to section 557 of this title, except as witness

or counsel in public proceedings. This subsection does not apply—

(A) in determining applications for initial licenses;

(B) to proceedings involving the validity or application of rates, facilities, or practices of public utilities or carriers; or

(C) to the agency or a member or members of the body comprising the agency.

(e) The agency, with like effect as in the case of other orders, and in its sound discretion, may issue a declaratory order to terminate a controversy or remove uncertainty.

2. Administrative Procedure Act of 1946, Section 8, as recodified, 80 Stat. 378 (1966), 5 U.S.C. § 557:

§ 557. Initial decisions; conclusiveness; review by agency; submissions by parties; contents of decisions; record

(a) This section applies, according to the provisions thereof, when a hearing is required to be conducted in accordance with section 556 of this title.

(b) When the agency did not preside at the reception of the evidence, the presiding employee or, in cases not subject to section 554(d) of this title, an employee qualified to preside at hearings pursuant to section 556 of this title, shall initially decide the case unless the agency requires, either in specific cases or by general rule, the entire record to be certified to it for decision. When the presiding employee makes an initial decision, that decision then becomes the decision of the agency without further proceedings unless there is an appeal to, or review on motion of, the agency within time provided by rule. On appeal from or review of the initial decision, the agency has all the powers which it would have in making the initial decision except as it may limit the issues on notice or by rule. When the agency makes the decision without having presided at

the reception of the evidence, the presiding employee or an employee qualified to preside at hearings pursuant to section 556 of this title shall first recommend a decision, except that in rule making or determining applications for initial licenses—

(1) instead thereof the agency may issue a tentative decision or one of its responsible employees may recommend a decision; or

(2) this procedure may be omitted in a case in which the agency finds on the record that due and timely execution of its functions imperatively and unavoidably so requires.

(c) Before a recommended, initial, or tentative decision, or a decision on agency review of the decision of subordinate employees, the parties are entitled to a reasonable opportunity to submit for the consideration of the employees participating in the decisions—

(1) proposed findings and conclusions; or

(2) exceptions to the decisions or recommended decisions of subordinate employees or to tentative agency decisions; and

(3) supporting reasons for the exceptions or proposed findings or conclusions.

The record shall show the ruling on each finding, conclusion, or exception presented. All decisions, including initial, recommended, and tentative decisions, are a part of the record and shall include a statement of—

(A) findings and conclusions, and the reasons or basis therefor, on all the material issues of fact, law, or discretion presented on the record; and

(B) the appropriate rule, order, sanction, relief, or denial thereof.

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JOINT

BRIEF

PREME COURT, U. S.

Nos. 90, Et Al.

FILED
OCT 9 1967
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In The

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1967

PERMIAN BASIN AREA RATE CASES

On Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

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Joint Brief of Texas Producer Associations

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OPINIONS BELOW

The decision of the Hearing Examiner in the Permian Basin Area Rate cases is reported at 34 F.P.C. 306 (1964). The opinions and orders of the Federal Power Commission (hereinafter "Commission") are reported at 34 F.P.C. 159 (1965), 34 F.P.C. 424 (1965), 34 F.P.C. 1068 (1965), and 34 F.P.C. 1082 (1965). The opinion of the United States Court of Appeals for the Tenth Circuit, including its opinion on rehearing, is reported at 375 F. 2d 6 (10th Cir. 1967).

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[1]Consisting of Respondents Texas Independent Producers and Royalty Owners Association and West Central Texas Oil and Gas Association.

JURISDICTION

The judgments of the Court of Appeals setting aside the Commission's order were entered on January 20, 1967. These judgments were modified by an order on rehearing entered on April 18, 1967. Petitions for certiorari were timely filed by the Federal Power Commission, the states of Texas, New Mexico and California and various producer and distributor interests. Certiorari and the motion to supplement petitions for certiorari were granted by this Court on June 12, 1967. The jurisdiction of this Court rests on 28 U.S.C. 1254 (1) and Section 19(b) of the Natural Gas Act, 15 U.S.C. 717r(b).

QUESTIONS PRESENTED

1. Must the Commission, under the Natural Gas Act, make a finding that the revenue requirements of the area producers as a group will be met by rates having the ceiling and floor fixed by the Commission?

2. Whether the area rates prescribed by the Commission for the Permian Basin Area are just and reasonable?

3. May the Commission lawfully order refunds in an area rate hearing where the revenues of producers are below their revenue requirements as determined by the Commission?

While the petitions for certorari have raised many additional questions detailed in the brief of the Federal Power Commission, the three questions above appear to be central and controlling on the disposition of this case.

STATUTES INVOLVED

The pertinent provisions of the Natural Gas Act, 15 U.S.C., Sections 717-717w, are reproduced in the appendix of the brief of the Federal Power Commis-

sion, previously filed and are incorporated herein by reference.

STATEMENT

Inasmuch as this is the first Commission decision under the area rate procedure to reach appellate review, it will serve as the bellwether for all of the other such areas. This Court's decision in this cause will be as important and far reaching as the First Phillips case.[2]

Certainly this Court's review of the first area decision will be of national importance to the gas industry and to its consumers. It is of crucial importance to the small producers of natural gas, whose rates and procedures, as finally determined by the Commission will decide their continuation in, or demise from, the natural gas industry.

Since the length of time and the expense involved prevented small independent producers from actively participating as individuals in the area rate proceeding, these two small producer associations intervened and tried to serve as the representatives for the hundreds of respondents who would have otherwise been unrepresented.

When the Federal Power Commission first made its announcement of its plan to use area pricing to price gas as gas and to end its fruitless and confusing attempts to price separately the natural gas of thousands of individuals engaged in the gas producing industry, most small producers, and the associations representing them, expressed their praise and acclaim.

These associations, who then represented over 7000 small producers and royalty owners, hailed the area pricing concept as a great forward stride to realism, logic and equity in the regulations which this Court

[2] *Phillips Petroleum Company v. Wisconsin*, 347 U.S. 672 (1954).

had said was required under the Natural Gas Act in the First Phillips case, supra.

In its Statement of General Policy No. 61-1 issued September 28, 1960, the Commission emphasized the problem of its jurisdiction over independent producers as "natural-gas companies" under the Natural Gas Act, and said:

> "Two price standards are set for each area. Initial prices in new contracts are, and in many cases by virtue of economic factors, must be higher than the prices in existing contracts. *It is anticipated that these differences in price levels will be reduced and eventually eliminated as subsequent experience brings about revisions in the prices in the various areas.*" (12 O&GR 1229)[3]

Producers thus hoped for a single uniform price for natural gas on which they could plan their exploration and development programs.

In Opinion No. 338 referred to in the General Policy Statement above, and issued on the same date, the Commission spelled out its reasons for adopting the area pricing procedure. The Commission stated

> "Producers of natural gas cannot, by any stretch of the imagination, be properly classified as traditional public utilities. Justice Harlan, dissenting in the recent case of *Sunray Oil Co. v. FPC*, 364 U.S. 137 at p. 160 characterized the difference as follows:
>
> "'A pipeline performs a service akin to those traditionally performed by public utilities. The independent producer, on the other hand, is unique among the objects of public-utility regulation because it is not engaged in rendering a service to the public in the conventional sense of that concept, but rather simply in selling a *commodity* which it owns. . .'

[3]Emphasis added throughout unless otherwise indicated.

"A natural gas pipeline, under our regulation, usually has a fair opportunity to earn a fair rate of return, but such is not necessarily the case with a producer. The pipeline investor is reasonably assured of the financial feasibility of a project before any funds are expended for construction. The pipeline constructs facilities only after the issuance of a certificate of public convenience and necessity and reasonable assurance of fair rates. The producer must invest his funds prior to ascertaining whether he will have anything to sell or whether, if he does, he will have an adequate market. Thus it is clear that in regulating producers, we are faced with problems entirely different from those presented by an ordinary public utility. Furthermore, to fix rates of gas producers simply by allowing a return on investment or rate base will penalize the efficient or fortunate producer and will unduly reward the inefficient or unfortunate producer. As Justice Jackson put it in his dissent in *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 at 649:

> "'... The service one renders to society in the gas business is measured by what he gets out of the ground, not by what he puts into it, and there is little more relation between the investment and the result than in a game of poker.'" (13 0&GR 347)

The Commission detailed cogent and compelling reasons for its area price procedures, all of which lead to the conclusion that gas should be priced as a commodity, and at a price high enough to lead independent producers to take the poker-like risks of gas exploration and development.

The Commission's determination to dispense with individual cost-of-service pricing roused understandable hope among small producers, who, because of the limited scope of their individual operations, could not

afford to present the detailed cost-of-service presentations previously required, nor the lengthy and costly Washington administrative hearings and subsequent court appeals necessary under the prior system.

Unfortunately, the decision of the Commission in the opinions and orders for which review is here sought, have dashed the hopes of small producers for a realistic method of area pricing.

As pointed out in the Examiner's decision, the small producers made a single presentation through these respondent associations (R. 106d). The Examiner stated (R. 108d):

> "TIPRO urges that prices be set between 17 cents and 21.8 cents per Mcf, with variations for physical or chemical qualities of the gas, if differing from pipeline quality. TIPRO also recommends that 13.5 cents be adopted as a minimum price, plus or minus quality differentials, and that all rates at that level be gradually raised by periodic escalation to the 17-21.5 cent level."

While the Commission adapted two of these suggestions, that is, the use of minimum prices and quality differentials, the base prices adopted by the Commission so distort the original concept as to make them of little value to the members of these respondent associations.

The Commission announced a special regulatory treatment for small producers which does recognize the overwhelming problems faced by a small producer in Federal regulation (R. 679d, 680d). It did so for the purpose of "streamlining the regulatory process without the risk of substantial impact on consumer prices" (R. 677d). The Commission went on to state the point which these respondents feel is compelling:

> "Consumers and the natural gas industry alike have a strong stake in the continuing exploration efforts of the thousands of small operators, who contribute a large share of the discoveries of new sources of gas. Easing the burdens of regulation would help to assure their continued participation in the gas production business" (R. 677d).

In contrast, the Hearing Examiner had provided a method of exemption of small producers and found all their rates to be just and reasonable (R. 237d).[4]

As the Commission pointed out (R. 675d, 676d):

> "There have been many suggestions, foremost of which are those of Justice Clark dissenting in *Wisconsin v. FPC*, 373 U.S. 294, 329-30 (1963), and speaking for the Court in *FPC v. Hunt*, 376 U.S. 515 (1964), to the effect that this Commission should consider procedures for the exemption of small producers from regulation."

The importance of the small producer in providing gas for the future cannot be over-emphasized. In 1957, small producers (those other than the sixty largest producers) completed 74.5 percent of the U.S. total net wells of that year. In 1961, the small producers (other than the sixty largest) completed 73.99 percent of the total (as stipulated: R. 1374, 1375).

The contribution of the small producer in drilling approximately three-fourths of all wells is hard to reconcile with the statement by the Commission that "small producers represent only fifteen percent of the aggregate interstate gas supply (R. 676d, 678d)," but the answer is contained in the record (R. 1774) where

[4]Small producers did not request exemption because they felt elimination of their cost experience would lower the overall ceiling (R. 1691, 1692) but when the Examiner suggested exemption (R. 1693) these associations recognized the benefits it would confer (R. 1694).

it is pointed out that the small independent producer does engage in drilling the poorer prospects and ranker wildcats, except for the extremely deep exploration where financial limitations will not permit his participation. Similarly, the small independent producers usually drill the properties on the fringe of the producing fields and therefore have a much larger portion of marginal properties than do the major integrated companies. The blocks and leases available for farmout to small producers by the major integrated companies are considered the least likely to produce (R. 1774).

The small producer has been, and properly should continue to be, an essential part of the exploration for, and production of, natural gas in the Permian Basin and all other producing areas of the nation.

As pointed out below, the Commission opinions and orders herein will fail to provide the necessary incentive to stimulate the small producer to continue the search for this nation's needed natural gas reserves.

ARGUMENT

These associations submit that the judgment of the Court of Appeals below should be affirmed by this Honorable Court, insofar as the Court of Appeals requires a finding by the Commission of revenue requirements.[5] In addition, this Court should also recognize that the small producer will be the first quick victim of the area price system if the Commission's original orders are upheld.

In the final oral argument before the Federal Power Commission, these associations joined with all producer-respondents below in asking that the Permian Basin

[5] *Burlington Truck Lines, Inc. v. United States*, 371 U.S. 156 (1962) requires that agency findings of fact must cover the essential issues and be stated with clarity to permit judicial review of the conclusions.

area price be established at 20 cents per Mcf, which request was supported by the overwhelming weight of evidence in the hearing. Instead, the Commission issued its Opinion 468, containing the depressed and unrealistically low dual price system, with absolute ceilings for premium quality new gas well gas at 16.5 cents per Mcf and for old "flowing" gas at 14.5 cents per Mcf.

The basic and quite fundamental error of the Commission is to use a costing technique long since discredited and without any merit of logic whatever. Stated as simply as possible, the Commission used an *average* of what it termed "costs" to determine a *ceiling* of prices for all producers. It is readily apparent that if an average of costs is to be utilized, the Commission must then grant this *average* as the *average* price, else it will confiscate the property of all of those whose individual costs are higher than the average. The Commission made no pretense of meeting this elemental criterion, and therefore erred as a matter of substantive law. If (as the Commission concluded) composites of costs are to be used to arrive at an "average cost" serving as the "touchstone" of a prescribed rate structure, the "average cost" figure cannot be a maximum ceiling price, but can serve only as a "base point" *above* and *below* which prices may fall so that *aggregate* revenues from *all* regulated rates may approach the aggregate revenue requirement indicated by "average" costs. If as the Commission concluded, the statute does not preclude group procedures for determining "reasonable" rates applicable to the industry in a given area, the rates prescribed for the industry as a group—in this instance in the Permian Basin area—still cannot be held substantively "just and reasonable" under Section 4 of the Natural Gas Act, when, as here, it is demonstrable that those prescribed rates preclude *opportunity* for the group as an entity to recover costs

computed on a group basis and a return amount found reasonable on a group basis.

Actually, the Commissions' cost figures rely heavily on the costs of major producers as pointed out in its Opinion 468 (R. 579d). There, in a footnote, the Commission stated "the questionnaire data includes costs from a few producers of less than ten million Mcf who also responded to the questionnaire. However, the inclusion of this data does not affect the results."

If cost data is to meet the promised requirement to determine the revenue needs of the industry, it must be realistic and reasonable and should include the costs of those producers selling both inter-and intrastate, and the costs of those wildcatters who found nothing and who have gone out of business, or have found gas and are shut-in for lack of a market. The Commission's cost figures do not contain these elements. Thus, despite the Commission's statement that it fixed the price of flowing gas "on the basis of a historical cost determination, as verified by the Examiner's approach" (R. 645d), the evidence it used did not include approximately 240 million Mcf produced by small producers who did not, or could not, report on the questionnaire (R. 1121). The Commission Staff Witness Lundy Wright stated that the small producer questionnaire from those who could report showed average unit costs of 2 cents per Mcf higher than the large company respondents (R. 1114, 1115).

It would seem clear that this Court felt that the Federal Power Commission promised that it would determine "fair prices for gas based on reasonable financial requirements of the industry." This language was a precise quote from the Commission's previous order, restated in *Wisconsin v. FPC*, 373 U.S. 296 (1963), where this Court said (p. 298 and 299):

"Over one year later, in September 1960, the Commission issued the opinion that is the subject of the present litigation. 24 FPC 537. Its basic conclusion was that the individual company cost-of-service method, based on theories of original cost and prudent investment, was not workable or desirable method for determining the rates of independent producers and that the 'ultimate solution' lay in what has come to be known as the area rate approach: 'the *determination of fair prices for gas, based on reasonable financial requirements of the industry' for each of the various producing areas of the country*. 24 FPC, at 547. This means that rates would be established on an area basis, rather than on an individual company basis."

Confirming that the cost data used by the Commission (which excluded the experiences of the hundreds of small producer respondents) is not and cannot be useful to determine the revenue requirements of the industry is the following analysis by producers' Witness Foster, who after studying the operations of producers in five different sized groups, determined that:

(1) Dry-hole costs amount to 4.7% of the revenues of companies in the largest size group, while this expense represents 37.% of revenues for companies in the smallest size category (R. 1293).

(2) Total drilling costs represent an average of 21.4% of revenues for the largest producers, while representing 96.9% of revenues for the smallest producers (R. 1293).

(3) Drilling costs expressed as a percentage of total gas revenues were found to be 23.5% for the largest producers, while amounting to 102.7% of the revenues for the marketed production of gas for the smallest producers (R. 1294).

(4) Considering the relation of expenditures to revenues, the costs of wages, salaries, supplies and fuel, construction work and purchased machinery representing 41.9% of revenues of the largest producers, while representing 73.3% of revenues for the smallest producers (R. 1295).

(5) In the current proceeding, even with its meager categorical breakdown, Witness Foster found that expenditures in relation to gross revenues proved to be 81.1% for the small producers as compared with 73.7% for the larger producers (R. 1297).

Justice Clark referred to the costs of large and small producers in his opinion in *Wisconsin v. FPC*, 373 U.S. 294 (1963) when he stated:

> "*The integrated producer of large volume is inevitably going to be the low cost producer.* Hence his rate will be an effective floor from which the small producer rates might well be adjusted. This would give the consumer rate protection and would give assurances to the small producer that he would be protected from confiscation."

The Court below rejected the argument of these associations that the higher costs of the small producer should result in a higher area rate for all producers. The Court stated (at XII R.p.48):

> "TIPRO and Big Chief both emphasize the testimony of a staff witness that the small producer questionnaire showed average unit costs 2 cents per Mcf higher than those of the majors. They argue that the end result standards must be applied not only to the entire group but to them as a group. The weakness of the argument is that once the group is split the process can be carried on until the regulation is back on an individual company basis."

The Court of Appeals below missed the thrust of our argument. No party sought to splinter the groups, but to show the Commission and the appellate courts that the ceiling set on the averages of the major companies must confiscate the property of the small producer. Nor is the exemption clause of value to the small producer, no matter how drafted, because he cannot afford a lengthy and expensive Federal Power Commission hearing, only to be told, if successful, that he can abandon his sale. In many cases the pipeline he sells to is the only one within miles of the producing field and abandonment will only leave him shut-in and subject to drainage.

In the argument above presented, the point is made that the Commission's use of *average* "costs" cannot possibly determine the just and reasonable rate, unless the average is a base or minimum price and unless the costs include the costs of all of the producing industry. Thus the determination by the Commission as above set out does not comply with the statutory responsibilities imposed upon it by the Natural Gas Act to regulate the industry in the public interest.

While the Commission's action is improper and should be struck down by this Court, a proper method of regulation was detailed by Justice Jackson in *Colorado Interstate Gas Co. v. FPC*, 324 U.S. 581 at 612 (1945) (Concurring Opinion) where he stated:

> "Far-sighted gas-rate regulation will concern itself with the present and future, rather than with the past, as the ratebase formula does. It will take account of conditions and trends at the source of the supply being regulated. It will use price as a tool to bring goods to market—to obtain for the public service the needed amount of gas. Once a price is reached that will do that, there is no legal or economic reason to go higher and any rate above one that

> will perform this function is unwarranted.*** On the other hand, if the supply is not too plentiful and the price is not a sufficient incentive to exploit it and fails to bring forth the quantity needed, the price is unwisely low, even if it does square perfectly with somebody's idea of return on a 'rate base.'"

In *FPC v. Hope Natural Gas Company*, 320 U.S. 591 (1943) this Court pointed out that the protection of independent producers was one of the aims of the National Congress in drawing up the Natural Gas Act. The Court stated at page 610:

> "The primary aim of this legislation was to protect consumers against exploitation at the hands of natural gas companies. Due to the hiatus in regulation which resulted from the *Kansas Gas Co.* case and related decisions, state commissions found it difficult or impossible to discover what it costs interstate pipe-line companies to deliver gas within the consuming states; and thus they were thwarted in local regulation. H. Rep. No. 709, supra, p. 3. Moreover, the investigations of the Federal Trade Commission had disclosed that the majority of the pipeline mileage in the country used to transport natural gas, together with an increasing percentage of the natural gas supply for pipe-line transportation, had been acquired by a handful of holding companies. State commissions, *independent producers*, and communities having or seeking the service were growing quite helpless against these combinations. These were the types of problems with which those participating in the hearings were preoccupied. Congress addressed itself to those specific evils."

The record is replete with testimony that past incentives have not been sufficient to encourage needed exploration, but perhaps none of this evidence was

more explicit than that of Witness O'Hern. Banker John O'Hern of Odessa testified as to the constriction of the exploration industry in the Permian Basin and pointed out that the number of rotary rigs in the Basin decreased from a 1952 average of 616 to a 1961 average of 219 (R. 256). He said:

> "With the decrease of drilling activities and number of independent operators, the constrictions and unhealthy supply and oil well servicing business in this area, shows, without any doubt, that exploration activities in the Permian Basin Area are decreasing in attractiveness at a dramatic rate compared to a period as recent as five years ago. This is further borne out by my experience in the bank, as I have seen a definite trend of capital flowing away from oil and gas activity... An assured, stable, and adequate gas price would increase exploration activity and would greatly increase the economic stability of the entire Permian Basin Area" (R. 256, 257).

Despite the uncontradicted testimony of Witness O'Hern and many others, the Commission by Opinion 468 *cut* the already inadequate revenues of the industry in the Permian Basin Area by approximately $32,000,000 (Federal Power Commission Brief, p. 98, FN 37).

In view of the matters set out above, the Commission erred in failing to meet its statutory responsibility to assure adequate supplies of natural gas to the nation and to protect the interests of the public.

In announcing its original "in-line" rates for the various areas, supra, the Commission apologized for pricing "old" and "new" gas at different rates and indicated that this differential would be gradually lessened and eventually abandoned. Instead, the Commission, as pointed out above, in Opinion 468 has encouraged new

differentiations in rates for gas of similar or identical quality, based only upon the contract date by which such gas was committed to interstate commerce. In the hearing below, the dual pricing system was largely the child of Witness Kahn (R. 709) who enunciated the concept of springing the regulatory trap on "old" gas by the enforcement of a separate and lower rate. The "old" gas entrapment theory suffers from two major defects of principle. First, it results in the completely inequitable treatment of investment in this "old" gas by substituting a return or earning which is far below that level which induced the initial commitment of capital. Just because risks have been taken and the costs of risk-taking already have been borne, it is totally inequitable to deprive producers of whatever may have been the benefits of that risk-taking. Quite obviously, this discriminatory treatment of old gas would have a direct and adverse economic effect such as the restriction of exploration and development on yet untested and undeveloped acreage under old contracts. The complete impairment of confidence in the administrative process resulting from such action must be self-evident.

The second reason why separate old gas and new gas ceilings are demonstrably wrong in principle is the fact that they fail to recognize that the commodity value of gas does not depend upon the date of discovery or development of the gas supply, nor the happenstance of a contract date. Neither does such value depend on the difference between non-associated, associated, or residue gas type, when these are delivered under comparable pressure and quality specifications. Practical problems are also involved in the application of any such ceiling standard which departs so from conditions in the industry and from the principles of simple economics. A number of these problems were

raised on cross-examination of Dr. Kahn in the record (R. 657, 668, 684).

All of the witnesses of these small producer association Respondents commended the area price concept as a forward step to reason and equity in natural gas pricing, but conditioned absolute endorsement upon establishment of a *single* realistic price, adequate but no higher than necessary to provide for producers the incentive and revenues to explore for and develop the supply needed to meet the demands of the consumers. This the Commission failed to do.

The distinction by type of gas will also materially impair the efforts of the states to conserve natural resources.[6]

Texas Railroad Commissioner William J. Murray graphically detailed the harmful results to consumers that will result from penalizing gas in price by type. He stated:

> "Since both oil prices and oil production are severely depressed at this time with little likelihood of improvement soon, the price of casinghead will certainly determine the abandonment date of this (marginal) well. Each penny more per thousand cubic feet of casinghead would postpone the abandonment of such a well and the reserves it represents" (R. 1397).

Commissioner Murray recommended:

> "... a rate low enough to protect consumers yet high enough to encourage needed new exploration and development. It is my view also that one uniform and stable price similar to our posted prices for crude oil would greatly benefit consumers and the industry alike. Par-

[6]The price paid for casinghead gas made possible the development of the Spraberry Field (R. 1654). Such conservation efforts have made possible the saving of 15 trillion cubic feet of natural gas in 10 years (R. 1397).

> ticularly I would recommend that the Federal Power Commission not penalize casinghead gas by establishing a lower price for it than for identical or similar gas well gas" (R. 1400).

Witness Malcolm Abel stated that a differential by types of gas would not be reasonable and would injure the industry (R. 1391). On occasion, raw casinghead bought at the lease by an interstate pipeline would be more valuable than gas well gas (R. 1392).

The overwhelming weight of the evidence in the hearing below indicated that a single uniform area price was needed, and that such area price should be higher than the formerly existing price for natural gas in view of the distress of the Permian Basin Area gas industry detailed by the producer witnesses.

The depressing effect of the Federal Power Commission Permian Basin opinion has resulted in driving new Permian Basin gas supplies into the intrastate market. See e.g. *Intrastate Firms Hustle for Texas Gas*, Oil and Gas Journal, September 11, 1967, p. 47. *Intrastate Market Seen As Boom for Texas Gas*, Dallas Morning News, September 15, 1967, p. 3d. These articles report two large intrastate firms plan new big diameter lines to transport natural gas from the Permian Basin.

In its Opinion 468 the Commission spells out its sources of costs stating (R. 577d):

> "A word of explanation is in order as to the variety of data sources utilized for determining the costs of gas in this proceeding. The natural gas producers, unlike electric power companies and natural gas pipelines, have not as yet been required to conform their books to a uniform system of accounts. The petroleum producers typically do not reveal their cost experience or accounting treatment in depth. When this proceeding was initiated there were no statistics

available based on a uniform set of accounts to provide the necessary information for making the cost determinations in this proceeding. *The cost questionnaire promulgated by the Commission was designed to fill this information gap in part and the responses have supplied a vital source of information for determining costs in this proceeding.* In addition Census data and other well-recognized and authoritative industry data sources were utilized by various witnesses in the proceeding. The record is thus built upon a variety of sources which we believe in combination provide an adequate basis for the costs we have found."

When the Commission later reached the question of exploration and development costs, and particularly the dry-hole costs so crucial to small producers because of the number of wildcats they drill (as set out above) the Commission stated (R. 579d):

"Since there were no such census costs available for 1960, he (the Examiner) established a trend for such costs by comparing 1958 and 1960 cost data obtained, in response to the questionnaire circulated by this Commission, *from producers of more than 10 million Mcf annually*, producing in the Permian Basin. He then adjusted the 1958 Census figures in accordance with the trend established from the questionnaire data to establish the 1960 costs.

"The Major Producer Group objects to the examiner's use of questionnaire data to establish a trend in E & D cost from 1958 to 1960 and adjusting the 1958 Census figures on the basis of the trend established. We think the examiner was correct in determining that the questionnaire data are valid for purposes of establishing a trend in the entire industry. We adopt the reasoning of the initial decision upon this point, and the 1.42 cents per Mcf cost, as set forth in Appendix B, pages 1 and 2."

Finally in summarizing its analysis of the costs of flowing gas the Commission states "as we noted at the outset we place primary reliance on the historical test-year cost of service presentation" (R. 639d).

The Commission's reliance on costs is entirely misplaced for two reasons:

(1) Due to the hundreds of small independent producer respondents who could not file a questionnaire because of the absolute lack of any uniform system of accounts, the cost evidence in this or any other proceeding must consist of a few facts and a volume of trends based on guesswork.

(2) The revenue needs of the industry, which the Commission is really trying to determine, can best be determined by an analysis of the industry as a result of five years of "in-line" pricing. That condition, as pointed out above, is critical, and the industry deserves and must have more, and not less, revenue. Yet the Commission apparently ignored all of the evidence concerning the need for additional revenue and adopted the average cost method of determining rates for the Permian Basin.

Also, as pointed out above, the data missing from all of the cost studies is the data of small producers who are the traditional wildcatters of the industry. Staff Witness Wright admitted that the small producer questionnaire showed average unit costs of 2 cents per Mcf higher than the major company respondents (R. 1114, 1115). Justice Clark guessed the same result in *Wisconsin v. FPC*, supra, when he stated "the integrated producer of large volume is inevitably going to be the low cost producer." In the same dissent, Justice Clark saw an evil end to the area rate proceeding, stating "As a consequence the consumers of gas all over the U.S. and particularly in the large metropolitan

cities along the eastern seaboard, mid-west and the west coast will pay for the Commission's area pricing wild goose chase. *I predict that in the end the consumer will find himself to be the biggest goose of the hunt and the small producer the dead duck.*"

The witnesses of these associations conclusively established below that even with existing revenues the small producer ranks are rapidly thinning. TIPRO Witness Malcolm Abel pointed out that the people dropping out of the search for natural gas are the small independent operators who historically have made most of the new discoveries (R. 227).

All producers have a high rate of risk, but the unusual and unique risks of the small producer were spelled out in detail (R. 229-237) by Witness Abel, sponsored by these Associations. The small producer cannot spread his dry hole losses over a great volume of production and a long period of time (R. 236). The small independent producer drills more dry holes for a discovery than do the major companies (R. 236). The mortality rate, or percentage of business failures, is greater among the small producers particularly in the present situation where the price for production discovered is not adequate to justify the risks (R. 236, 237). The typical small producer cannot build gathering and other pipeline facilities (R. 237).

It is abundantly evident from the record before this Honorable Court that as a result of the opinions and orders complained of, the "duck" mentioned by Justice Clark is dying.

If this Court upholds the action of the Commission in establishing maximum or ceiling rates limited to the average cost, then the Commission should set minimum rates which would assure sellers of natural gas an effective remedy to recover such average cost. Since the

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a group can be satisfied with rates having the ceiling and the floor which the Commission has fixed" (XII R. 56).

Since the Commission did not determine the revenue requirements of the producers, did not utilize the costs of small producers, ignored evidence of the attrition rate among small producers, drilling concerns and supply firms, reduced already insufficient revenues, and requires over $30 million in refunds, this Court should affirm the Court of Appeals below and remand this proceeding to fill the evidentiary gaps.

The brief of the parties supporting the FPC Opinions and Orders herein urge that this Court immediately affirm the Commission in all points and thereby avoid delay.

While past delays have been a source of considerable problem to the parties and the Commission, the delay which would be occasioned by a short hearing before the Commission to determine the revenue requirements of the industry and other matters pertinent to the remand would be quite brief.[7]

As far as the other area rate cases are concerned (Docket Numbers AR64-1, AR64-2, and AR67-1), the position of the parties is that evidence received or tendered in those cases would provide a basis for necessary findings set out by the Tenth Circuit. For example, the brief of the Associated Gas Distributors Group states (at page 12):

> "While from the reasons indicated in the Order on rehearing, the Commission was unable in Permian to make a precise determination as to a cost-revenue balance, there is no

[7]The Commission can immediately make any required supplementation of the Administrative record and could promptly determine the additional findings required by the Tenth Circuit's remand directive.

> similar impediment in other pending area cases, and it is our expectation that such a balance will be forthcoming in other area cases."

The producers are just as anxious to secure a final determination as are other parties and agree with the statement of the Court in *FPC v. Hunt*, 376 U.S. 517, at page 527, where the Court said:

> "However, we again call to its attention the dangers inherent in the accumulation of a large backlog of cases with its accompanying irreparable injury to the parties. Moreover, consumers may become directly affected thereby through the reluctance of producers to enter interstate markets because of the long delay incident to permanent certification. Procedures must be worked out, not only to clear up this docket congestion, but also, to maintain a reasonably clear current docket so that hearings may be had without inordinate delay. In this connection the techniques of the National Labor Relations Board might be studied with a view to determining whether its exemption practices, see *Guss v. Utah Labor Relations Board*, 353 U.S. 1, 3-4, 77 S. Ct. 598, 599, 1 L. Ed. 2d 601 (1957), might be helpful in the solution of the Commission's problems.

The refund question is of vital concern to all small producers. As pointed out above, the Examiner would not have required refunds of small producers, he having found their contract prices to be "just and reasonable." (R. 237d)[8]

The Commission, on the other hand, did not agree with this holding and would require refunds in each case when more than the maximum rate for that type of gas is collected.

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[8]Because of the limited nature of their operations, refunds by small producers would constitute a crippling financial blow.

The Court of Appeals would not require refunds unless group revenues exceeded group revenue requirements. (XII R.89)

The treatment of refunds provided by the Court of Appeals below is fair, logical and in keeping with *Wisconsin v. Federal Power Commission*, supra. The Supreme Court of the United States held that the Commission was correct in not requiring refunds since the cost of service exceeded revenues, saying (at p. 306):

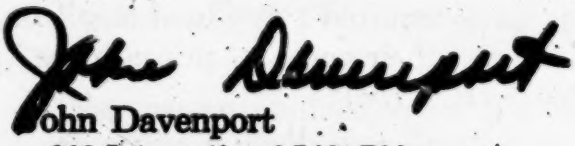
> "Having decided on a basis of substantial evidence that the increases did not bring revenues up to cost of service, the Commission properly concluded, on the only matter before it with respect to these dockets, that no refund obligation could be imposed."

In this cause, if producers as a group must suffer a revenue deficit there should be no refund requirement. To require refunds would only further penalize producers with such refund obligations.

CONCLUSION

For the foregoing reasons, the judgments of the Court of Appeals should be affirmed, and these cases remanded to the Commission for further proceedings.

Respectfully submitted,



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BRIEF

OCT 9 1967
JOHN F. DAVIS, CLER

Nos. 90, 95, 98, 99, 100, 101, 102, 105, 117, 181

In the

Supreme Court of the United States

OCTOBER TERM, 1967

THE PERMIAN BASIN AREA RATE CASES

On Writs of Certiorari to the United States Court of Appeals for the Tenth Circuit

BRIEF FOR HUNT OIL COMPANY, H. L. HUNT, LAMAR HUNT, N. B. HUNT, W. H. HUNT, SECURE TRUSTS, CAROLINE AND LLOYD B. SANDS, CAROLINE HUNT TRUST ESTATE, LYDA HUNT—CAROLINE TRUSTS, LYDA HUNT—BUNKER TRUSTS, LYDA HUNT—LAMAR TRUSTS, LYDA HUNT—HERBERT TRUSTS, LYDA HUNT—MARGARET TRUSTS (FORMERLY ESTATE OF LYDA BUNKER HUNT, DECEASED), HUNT INDUSTRIES (FORMERLY ESTATE OF LYDA BUNKER HUNT, DECEASED), AND PLACID OIL COMPANY

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In the

Supreme Court of the United States

OCTOBER TERM, 1967

THE PERMIAN BASIN AREA RATE CASES

On Writs of Certiorari to the United States Court of Appeals for the Tenth Circuit

BRIEF FOR HUNT OIL COMPANY, H. L. HUNT, LAMAR HUNT, N. B. HUNT, W. H. HUNT, SECURE TRUSTS, CAROLINE AND LLOYD B. SANDS, CAROLINE HUNT TRUST ESTATE, LYDA HUNT—CAROLINE TRUSTS, LYDA HUNT—BUNKER TRUSTS, LYDA HUNT—LAMAR TRUSTS, LYDA HUNT—HERBERT TRUSTS, LYDA HUNT—MARGARET TRUSTS (FORMERLY ESTATE OF LYDA BUNKER HUNT, DECEASED), HUNT INDUSTRIES (FORMERLY ESTATE OF LYDA BUNKER HUNT, DECEASED), AND PLACID OIL COMPANY

OPINIONS BELOW

The opinion of the court of appeals (XII R. 15-61)[1] and its *per curiam* opinion on rehearing (XII R. 87-89) are re-

[1] For simplicity we will employ the system followed by the Federal Power Commission in making record citations which is: Testimony (Volumes I-V) "R. 1—R. 1908"; Exhibits (Volume VI-VIII) "R. 1e—R. 1146e"; Pleadings. Orders and Opinions in the Administrative proceeding, (Volumes IX-XI) "R. 1d—R. 1157d"; Proceedings in the court of appeals and this Court (Volume XII) "XII R. 1—XII R. 90". Supplementary Volume "R. 1s—R. 40s". The R. stands for Record in this Court and the page numbers in Volumes I through XI refer to the Joint Appendix page numbers in the court below and the Record page numbers in this Court and not to the Record page numbers in the administrative proceedings.

ported at 375 F. 2d 6. The opinion and orders of the Federal Power Commission (R. 516d-826d, 827d-838d, 37s-40s, 1105d-1132d, 1133d-1136d, 1154d-1155d and 1156d-1157d) are reported at 34 FPC 159, 418, 424, 1068, 1082, 1198, and 1288. The opinion of the Commission's hearing examiner (R. 97d-364d) is reported at 34 FPC 306.

JURISDICTION

The judgments of the court of appeals were entered on January 20, 1967 (XII R. 62-83). An order modifying the judgments was entered after rehearing on April 18, 1967. Hunt, *et al's* petition for certiorari in No. 101 was filed on April 19, 1967. On April 18, 1967, Mr. Justice White extended the time of the Federal Power Commission for filing a petition for writ of certiorari to June 19, 1967, and the Commission's petition No. 117 was filed on May 1, 1967. The dates of filing other petitions for certiorari and the circumstances relating thereto are contained in the jurisdictional section of the brief, page 2, for the Federal Power Commission. All of the petitions were granted on June 12, 1967 (XII R. 89-90). The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1) and § 19(b) of the Natural Gas Act, 15 U.S.C. § 717r(b).

STATUTES INVOLVED

The sections of the Natural Gas Act involving questions presented by the Federal Power Commission and others are printed in the Appendix to the brief for the Federal Power Commission, pages 173-181. The statutory and constitutional provision specifically involved in the questions presented in

this brief are § 4(a), and 5(a) of the National Gas Act 15 U.S.C. 717c(a), 717d(a), and the Fifth Amendment to the Constitution of the United States.

The pertinent parts are as follows:

Section 4, 15 U.S.C. § 717c

> "(a) All rates and charges made, demanded, or received by any natural gas-company for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges, shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful."

Section 5, 15 U.S.C. § 717d

> "(a) Whenever the Commission, after a hearing had upon its own motion or upon complaint of any State, municipality, State commission, or gas distributing company, shall find that any rate, charge, or classification demanded, observed, charged, or collected by any natural-gas company in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force and shall fix the same by order: *Provided, however,* That the Commission shall have no power to order any increase in any rate contained in the currently effective schedule of such natural-gas company on file with the Commission, unless such increase is in accordance with a new schedule filed by such natural-gas company; but the Commission may order a decrease where existing rates are unjust,

unduly discriminatory, preferential, otherwise unlawful, or not the lowest reasonable rates."

Amendment 5, United States Constitution

"No person shall be held to answer for a capital, or otherwise infamous crime, unless on a presentment or indictment of a Grand Jury, except in cases arising in the land or naval forces, or in the Militia, when in actual service in time of War or public danger; nor shall any person be subject for the same offence to be twice put in jeopardy of life or limb; nor shall be compelled in any criminal case to be a witness against himself, nor be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation."

QUESTIONS PRESENTED

The Federal Power Commission by refusing to receive evidence that would permit it to determine the impact of its order on individual companies and by arbitrarily gathering and compositing data (upon which the price for flowing gas and new gas-well gas was based) without regard to time of discovery and development, without regard to volumes, without regard to depth, and without regard to any other factor, fixed separate uniform ceiling rates subject only to quality adjustments for "flowing gas" and for "gas-well gas". Since ten petitions for certiorari have been filed, Hunt *et al.* will rely upon other producers to present many of the questions involved. The questions presented in this brief will be limited to those which we believe will not be adequately raised and presented by other parties but are vital to the determination of rates meeting both the statutory and con-

stitutional standards while assuring the maintenance of an adequate supply of gas. They are as follows:

I. Whether uniform ceiling rates fixed at the average composite unit cost level of a selected group of companies, without regard to any other factors, meet the constitutional requirement of assuring producers nonconfiscatory rates, meet the statutory requirement that all rates shall be just and reasonable and assure consumers the lowest reasonable rates consistent with the maintenance of adequate service when:

(1) the record shows average per unit test year revenues of only 13.05¢ per Mcf for gas-well gas and only 12.72¢ per Mcf for all test year gas sales (R. 538e) and the Commission found test year per unit costs of 14.39¢ per Mcf for flowing gas (R. 639d) and 16.43¢ per Mcf for new gas-well gas (R. 578d);

(2) only 16 of the 44 producer respondents (as revealed by the workpapers underlying Schedule 3 of Staff Exhibit 170 upon which the Commission relied) whose costs were used to compute the average unit cost of flowing gas will realize the 12% return found appropriate by the Commission;

(3) the Commission found that the small producers are essential to the welfare of the consumers (R. 677d) yet permitted them to receive little or no return;

(4) the consumers are required to pay for all costs incurred whether 1¢ or $10 per Mcf, but instead of reimbursing the producers who actually incurred such costs, the producers whose costs were below the average

would not only be reimbursed for actual cost incurred but in addition would be given a bonus equal in the aggregate to the costs incurred by other producers in excess of the average;

(5) the consumers under the area method will be required to pay millions of dollars more in rates (that is unit cost exceeds contract prices of many producers) than would be required under the individual company cost of service method assuming the same rate of return for individual producers as allowed for the group, and

(6) the two-price system adopted by the Commission will make future cost determinations of flowing gas administratively infeasible if not absolutely impossible (due to the data collection and allocation problems)?

II. Whether the Natural Gas Act and the Constitution will permit the Commission to impose uniform ceiling rates on all producers in an area regardless of the revenue impact on such producers in such area or in the Continental United States when:

(1) the sole basis for the uniform ceiling rate is the average composite cost of a selected group of producers;

(2) no finding has been made either

(a) that the average cost of the group is typical of the average cost of the individual producers, or

(b) that the composite operations of the group are typical of the operations of the individual producers, and

(3) the dispersion of unit costs between individual companies as shown by the Commission's own Staff

Exhibit No. 174 (R. 493e-530e) is so great as to demonstrate *per se* that the average unit cost could not be typical of the individual producers' costs?

III. Whether in fixing area rates on the basis of average composite costs of a selected group of producers under the just and reasonable standard of the Natural Gas Act and having due regard for the Constitutional prohibition against confiscation, the Commission can:

(1) reduce the rate or require refunds of any producer when average unit group costs exceed average unit group revenues; or

(2) reduce the rate or require refunds of a producer when such producer's prudently incurred company wide jurisdictional gas cost exceeds its company wide jurisdictional gas revenue?

STATEMENT

This case involves the Federal Power Commission's first attempt to fix just and reasonable rates for independent producers on an area basis.

This Court, by order of June 10, granted ten separate Petitions for Writs of Certiorari to the United States Court of Appeals for the Tenth Circuit, consolidated the cases for oral argument, and assigned eight hours for hearing of these cases and any other cases which may be granted with respect to "Permian Basin Area Rate Cases", (XII R. 90). Since the Federal Power Commission has already filed its brief containing a lengthy statement, and since we believe that the major integrated producers will also file a detailed

statement of the case, Hunt, *et al.* will include only a very abbreviated statement designed to give this Court the factual background for the questions presented in this brief.

The first major producer rate case to reach the Commission on the merits was the original *Phillips Case*, 24 FPC 537 (1960) on remand from this Court, *Phillips Petroleum Co. v. State of Wisconsin*, 347 U.S. 672 (1954). While utilizing individual company cost-of-service to pass upon a number of increased rate filings in that case, the Commission concluded that the individual company utility type cost-of-service approach was not appropriate for fixing just and reasonable producer rates for the future. This case is a direct outgrowth of that conclusion. (R. 538d-539d).

The hearing before the Commission consumed 258 actual hearing days (including prehearing conferences) during which time 337 main exhibits and numerous supplemental exhibits were received. The transcript consists of more than 30,000 pages.

The Commission refused to receive evidentiary data relating to individual companies (R. 32d). As a result, the examiner's decision, the Commission's Opinion and the court decision below are based solely upon consideration of selected group data. The Commission issued questionnaires (Appendices A, B and C) for the purpose of gathering cost and drilling data from the Permian Basin Area producers (R. 38d-46d, 47d-48d, 62d-65d). The questionnaires were not designed in a way that would permit the Commission and the other parties to classify such data as to time of discovery and development, size of recoverable reserves, annual

volumes produced, reservoirs, fields, depths or on any other basis; therefore, from the outset the usefulness of the data collected was severely limited.

The Appendix C cost questionnaires were sent to approximately 350 small producers, of which 105 responded. This data was completely ignored (R. 629d, 630d). The Appendix B cost questionnaires designed for major producers were completed by 68 producers, 43[2] having more than 10,000,000 Mcf of test year sales and 25 having less. The Commission relied exclusively on the Appendix B cost data for its determination of the cost of flowing gas (R. 629d, 630d). However, data of only 44 of the 68 producers were included in the Commission's cost computation.[3]

The Appendix A questionnaires were sent to all of the 336 producer respondents. (R. 48d, ordering paragraph (C)). Of this number, 240 were completed in a usable manner (R. 171d-172d). This data was used to a limited extent in computing the cost of new gas-well gas, but not the cost of flowing gas.

The Commission prescribed ceiling rates for more than 1400 producers operating in the Permian Basin Area

[2] One of such producers did not fill out the questionnaire in a usable manner (R.629d, 633d)

[3] The Commission, relying upon its Staff's composite cost-of-service presentation (R. 626d), found that "the production expense and investment data for gas-well leases which cover some two-thirds of the gas-well gas produced in the area is fully representative of the costs for gas-well gas" (R. 812d), and computed the cost from the data of the three gas lease classifications set forth in Exhibit No. 170, Schedule 3 (R. 429e). The underlying workpapers reveal that only 44 of the 68 producers had gas production in these three gas lease categories.

(R. 223) of which only 336 were named as party respondents (R. 529d). Another 2279 gas producers sell gas for processing in plants (R. 1242) and would be subject to those rates. Two ceiling rates were prescribed, one for new gas-well gas and one for flowing gas. New gas-well gas was defined as non-associated gas produced from dry gas reservoirs, gas condensate reservoirs and gas from gas-cap wells and residue gas derived therefrom sold under contracts executed on or after January 1, 1961 (R. 572d, 615d). Flowing gas was defined as all casinghead gas (oil well gas) and residue gas derived therefrom both old and new, and old gas-well gas and residue gas derived therefrom (R. 624d, 645d). Old gas-well gas is gas delivered under contracts dated prior to January 1, 1961 (R. 572d). In each case, the Commission used an average composite cost from selected data as the measure of the price (R. 573d, 574d, 626d).

The ceiling rate for new gas-well gas was fixed at the computed or estimated average cost level of finding and producing gas (R. 576d) by using a variety of so-called industry-wide data gathered by various organizations, governmental agencies and private concerns for purposes wholly unrelated to the determination of just and reasonable rates. (R. 577d, XII R. 40-41)

The ceiling rate for flowing gas was fixed at the average historical composite cost level (R. 626d) of a selected group of companies. The flowing gas cost was determined by using a combination of Permian Basin Area data for production costs (R. 627d & 628d) and national data for exploration and development cost (R. 634d) and by adding

regulatory expense (R. 590d) and state production taxes. (R. 615d, 645).

Both the new gas-well gas and flowing gas ceiling prices are only applicable to pipeline quality gas as defined by the Commission. Such prices are subject to quality adjustments. In each case the ceiling rate is to be reduced by an amount equivalent to the cost to the purchaser of bringing the gas up to specified standards (R. 654d, 690d-691d). The record does not contain data that would enable the Commission or the courts to determine the effect of the quality adjustments and the court below remanded the case to the Commission for such additional hearings as might be needed (XII R. 61) to determine the effect of the quality adjustments (XII R. 52) and to determine group revenue and group revenue requirements (costs) (XII R. 46, 54, 60-61).

The ceiling rates are to apply on a contract-by-contract basis (R. 687d-689d), regardless of the cost of the gas involved, the field unit cost, the area or company-wide cost of the producer, the time period in which the gas was discovered and developed, the depth of the reservoir or any other factor. The Commission also ordered refunds on a contract-by-contract basis of all amounts collected under Section 4 (e) proceedings in excess of the ceiling rates without determining whether there were individual or group revenue deficiencies for prior periods and regardless of any other considerations (R. 672d-675d, 695d-697d).

Petitioners and other producers filed petitions for review in the Tenth Circuit challenging the lawfulness of the rates fixed, the denial of the right of individual producers to submit

evidence showing their individual revenue requirements (costs), and the ordering of refunds.

The Court of Appeals for the Tenth Circuit issued its decision on January 20, 1967, reversing the Commission's Opinions 468 and 468-A in part and remanding such matters to the Commission for further proceedings. Essentially the remand directed the Commission to (1) hold such additional hearings as are needed to determine the effect of the quality adjustments and to determine the group revenues and group revenue requirements, (2) make appropriate findings on the above matters and (3) include in its new order an adequate provision for special relief for individual producers (XII R. 46, 50, 51, 52, 54, 60-61). However, the court of appeals affirmed the Commission's order in the following respects:

(1) The Commission's action in fixing uniform *ceiling* rates at the *average* composite cost level of a selected group of Respondents without regard for any factor other than composite cost.

(2) The Commission's failure to determine whether or not the average composite cost was typical of either the producers whose cost was used or of any of the remaining producers.

(3) The Commission's failure to determine whether or not the composite operations of such producers was typical of the group or any member of the group, or any of the remaining producers.

(4) The Commission's failure to receive evidence relating to individual producers and to consider the im-

pact or consequences of its rate order upon the individual producers.

(5) The Commission action in ordering refunds of all amounts collected in excess of the ceiling rates on a rate schedule by rate schedule basis without regard to the cost or revenue requirements of the individual producer or the group.

On rehearing the court below modified its earlier opinion with regard to refunds holding "that no refund obligation may be imposed for a period in which there is a group revenue difficiency" (XII R. 88-89).

SUMMARY OF ARGUMENT

We accept the principle that the Commission is free to use any method within statutory and constitutional limitations in fixing just and reasonable rates as long as its order "as applied to the facts before it and viewed in its entirety, produces no arbitrary results," *Federal Power Commission v. Natural Gas Pipeline Company*, 315 U.S. 575, 586 (1942), *Wisconsin v. Federal Power Commission*, 373 U.S. 294, 309 (1963), (XII R. 31-32), *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591, 602 (1944). And, we are mindful of "the heavy burden of making a convincing showing that it [the rate order] is invalid because it is unjust and unreasonable in its consequences," *Hope supra*, 320 U.S. at page 602. But, it is submitted that the consequences of the Commission's order here under review are so unjust and unreasonable as to compel the elimination of the harsh impact of *uniform ceiling* rates at *average* composite

cost levels on all gas and on all producers regardless of the cost of the gas and regardless of the circumstances.

We do not contend that the area approach is unlawful *per se*, but rather that the uniform rates established by the Commission do not meet statutory and constitutional requirements, nor do they accommodate the peculiar characteristics and circumstances of the natural gas producing industry.

A. A rate should not be so "high as to deprive consumers, or so low as to deprive producers of their right to a just and reasonable rate", *Wisconsin v. Federal Power Commission* 373 U.S. 294, 310 (1963). In order to accomplish this purpose, the rate must be high enough:

(a) to assure the consumer of an adequate supply of gas, *Atlantic Refining Company v. Public Service Commission of New York*, 360 U.S. 378, 388 (1959), and

(b) to allow the producer revenues to cover its legitimate expenses, to cover the interest on its debts, to pay sufficient dividends to continue to attract investors, and to retain sufficient surplus to finance its operations. *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591, 603 (1944).

The ceiling rates fixed by the Commission fall far short of these goals, because the rates are below the cost of approximately ½ of the volume of gas. The same ceiling rate applies to all flowing gas. For example, no distinction is made between gas discovered and developed at depths of 2,500 feet in 1945 or earlier and gas discovered and developed

at depths of 15,000 feet or deeper in 1958 or later. Likewise, the same ceiling rate applies to all new gas-well gas. No adjustment is made for gas that cost 30¢ per Mcf over gas that cost 5¢ per Mcf.

The ceiling rates for "flowing gas" and for "new gas-well gas" were fixed at the average composite cost of *sub-pipeline quality* "old gas-well gas" and "new gas-well gas" respectively. Though the rate is at the *sub-quality cost level*, it must still be reduced by an amount equivalent to the cost of bringing the gas up to standard. Also, the producer gets on a contract by contract basis the reduced rate or the contract rate whichever is lower. The result—revenue deficiency for the industry in the aggregate.

Increasing the ceiling rate sufficiently to offset the quality and contract limitations is only a partial answer. It will take an above average cost rate to make the owners of above average cost gas whole. It will take a below average cost rate to avoid paying windfalls to owners of below average cost gas. It will take above average cost rates and below average cost rates to avoid having the consumers reimburse some producers for costs incurred by other producers. Moreover, uniform ceiling rates will require consumers to pay all costs incurred whether 1¢ or $10.00 per Mcf.

B. The average composite unit cost of gas on a group basis is not typical or representative of the average cost of the different categories of gas or of the average cost of the individual owners of the gas. *Chicago and N.W. Ry. Co. v. Atchison T. & S.F. Ry. Co.*, ... U.S. ....., 87 S. Ct. 1585,

1595 (1967). The unit cost of gas is largely dependent upon nature, time, and rate of production. The dollar cost of finding gas almost doubled (increasing between 61 and 88%) over the period 1947 to 1960 (R. 134d). Other things being equal, unit cost of gas produced from large reservoirs is well below the unit cost of gas produced from small reservoirs. Doubling the reserves, without increasing total costs, cuts unit cost in half. Over ½ of the gas-well gas produced in the Permian Basin Area during the 1960 test year came from two fields and ¾ of such gas came from 13 fields, whereas the remaining ¼ was produced from 358 different fields. Increasing the rate of production also reduces unit cost. Thus, if a reserve is depleted in 10 years instead of 20 years, approximately ½ of the total operating costs would be saved thereby reducing the unit costs. The depth at which reservoirs are located also bears heavily upon unit cost because the cost per foot to drill increases geometrically with depth. Variations in the unit cost of gas is a fact of natural gas life. Nature did not see fit to locate gas in such a fashion as to permit its recovery at uniform unit costs. Therefore, the variations in the unit cost of gas are inherent in the gas itself and not controllable by the producers.

The wide variations inherent in the unit cost of gas are reflected in the average unit cost of producers. Thus, a producer who owns recently discovered reservoirs and small volume reservoirs, will necessarily have higher unit costs than a producer who owns predominantly old, shallow reservoirs or large volume reservoirs. The magniture of the differences in the cost among producers is indicated by Commission

staff witness Wright's array Exhibit No. 174 which shows gas-well gas costs ranging from 2.9¢ to 170.5¢ per Mcf (R. 499e-504e). There is no way for producers to achieve uniform unit costs from reservoirs with the "inherent variability in geological conditions over so large an area" as the Permian Basin (R. 775).

Where, as here, cost is the sole criteria for fixing rates and where unit costs vary to the extent shown in this record, basic fairness compels a rate structure that equitably reflects the varied costs.

C. The higher ceiling rate established for new gas-well gas to induce producers to continue exploration and to assure consumers adequate gas supplies is in reality a deterrent because it effectively destroys all incentive to explore for above average cost gas which is approximately ½ of the total to be discovered. The ceiling rate is equal to average unit cost. The average unit cost is below the cost of approximately one half of the gas. Producers know for a certainty that they will not be able to recover their cost of any gas that exceeds the average. Therefore, the 16.5¢ rate will only elicit 16.5¢ cost gas or gas that cost less.

D. Uniform rates instead of easing the administrative burden of regulating producers merely postpones the day when the Commission must come to grips with the problem on the merits. The Commission held that the success of its two-step uniform price system depended upon the rates for new gas-well gas remaining firm for the life of the reserve

except for the possibility of increases resulting from increased operating costs. Therefore, in the second round of area proceedings, the Commission will have to determine the average cost of reserves added (a) during the pre-1961 period, (b) the period 1961 through 1967, the end of the moratorium on rate increases, (c) the period 1968 to the date of new test year, and (d) during the test year. At that time classification of gas by categories will be mandatory, but it may well be too late to save scores of producers and to avoid a critical supply problem.

Regulating producers on an area group basis is not the time saver envisioned by the Commission. All of the volume, cost and revenue data of each of the producers whose data was composited by staff is already in data processing machines. With a few hours spent in programming and a flip of the switch, individual company cost studies for each member of the group could be calculated virtually as fast as composite group cost studies. Some additional analysis, evaluation an adjustments for test year abnormalities would complete the task.

E. Uniform ceiling rates at average cost levels cannot accommodate the peculiar characteristics of the natural gas producing industry. Dividing total cost by total volume to obtain average composite unit cost— ceiling rate— is about as arbitrary and capricious as one can get. Objectivity requires an analysis of the individual and the overall producer experience in the various reservoirs, fields, depths, and time periods. Fairness to the producer as well as the consumer requires that the rates comport with the economics

of the gas producing industry. To comport with the economics of the industry, the rates must reflect the variations in unit cost which are inherent in the gas itself.

F. When average costs are used to compute ceiling rates, the owners of above average unit cost gas will be hurt and the owners of below average unit cost gas will receive windfalls. Since producers will not look for above average cost gas, the exploration horizon will shrink each time a new average cost—ceiling price—is computed because each time the average cost will include a smaller percentage of the potential gas discoveries. After computing the average composite cost of old and new gas, the Commission considered several value factors and concluded that there was no reason to adjust the cost in determining ceiling prices. But, no effort was made to determine whether there was a reason for fixing a higher price for higher cost gas. The only way to adapt cost based rates to the natural gas producing industry is to conform the rate structure to the widely varying unit costs which are characteristic of the gas. This is an accepted principle of rate design. *Chicago & N. W. Ry Co. v. Atchison T. & S. F. Ry. Co.*, ... U.S. ....., 87 S. Ct. 1585, 1591-2, 1599-1603 (1967).

G. Uniform ceiling rates are no panacea for producer regulation. They are not only an effective barrier to exploration for above average cost gas which is absolutely essential if consumer needs are to be supplied, but are confiscatory to many producers, especially small producers, whose welfare is essential to the consumer. The inequities were demonstrated by the Commission in adopting the two-price system

to accommodate the 2¢ differential in average unit cost between flowing gas and new gas-well gas. If, as the Commission held, the two prices are necessary to avoid windfalls and provide incentives, the substantially greater difference in the cost of various categories of gas and in the per unit gas cost among producers compels a finding that higher rates are necessary for the higher cost gas to avoid windfalls and confiscation and to provide incentives.

Uniform rates for varying costs are contrary to all Commission precedent in pipeline rate cases and contrary to the Commission's action in severing the pipeline gas production issue out of the *Hugoton-Anadarko Area Rate Proceeding*, Docket No. AR64-1, *et al.* because of the alleged cost differential. The Commission has always required pipelines to reflect different costs in their rates. Likewise varying rates are prescribed to reflect the economies in volume transportation and sales. Not only that, but so far as we are aware, without a single exception, allowances are made in every industry for volume purchases and transportation. No reason has been shown, nor can be shown, for making a distinction for natural gas.

H. Special relief is not an appropriate or adequate remedy. The special circumstances relate to and are inherent in the gas as distinguished from the producer. The smaller producers, who as a rule, own a disproportionate amount of above average cost gas, do not have the ability or the legal power to gather and present area-wide data to show that their unit cost is no higher than the unit cost of comparable gas which may be owned in smaller proportions by the owners of be-

low average unit cost gas. The Commission has not gathered or considered such data in the main proceedings; *a fortiori* it would not gather such data in special proceedings. Showing one's unit cost to be higher than the area unit cost will not suffice because the Commission has already ruled that higher unit cost is not a basis for a higher rate. However, a higher rate, if granted, would only be effective for flowing gas since no purchaser would pay more than the ceiling rate for new gas. Relief limited to out-of-pocket expenses or abandonment as a practical matter amounts to liquidation.

ARGUMENT

I.

Uniform *Ceiling* Rates Fixed at *Average* Composite Cost Levels Are Confiscatory to Owners of Above Average Cost Gas, Provide Windfalls for Owners of Below Average Cost Gas, and Deter Exploration in the Face of a Growing Need for Gas

The order fixing ceiling rates at average composite cost levels, (1) is unjust and unreasonable in its consequences and, therefore, unlawful; (2) does not comport with the requirements of the Statute or the Constitution; and (3) defeats the purpose of the Act because it does not afford consumers the lowest reasonable rates consistent with the maintenance of adequate service. The inevitable results are to (a) deny some producers the right to recover their cost even to the extent their contract prices permit, (b) authorize some producers to recover all of their costs plus a portion of the cost incurred by other producers, (c) require consumers to reimburse some producers for costs incurred by other producers without any concomitant benefit to the consumers, (e) require consumers to pay substantially higher gas bills than would be the case if rates were fixed in the same manner on an individual company basis rather than on an area group basis, and (f) deter exploration for above average cost gas.

The absurdity of arbitrarily fixing *ceiling* rates at *average* cost levels when costs vary to the degree that this record indicates can be simply illustrated. Suppose Producer A has 1 Mcf of gas that cost 20¢ and Producer B has 1 Mcf of

gas that cost 10¢. The total cost would be 30¢ and the average cost 15¢ per Mcf; however, a price at the average cost level of 15¢ would not be representative or typical of either A or B. If such a price was imposed, A would be required to sell his gas at a loss of 5¢ per Mcf, while B would receive a 5¢ windfall.

A. *Uniform Ceiling Rates At Average Composite Cost Levels Are Inequitable, Unfair, Unjust, Unreasonable, Unduly Discriminatory, And Unlawful to Both The Producer And The Consumer*

As this Court stated in *Wisconsin v. Federal Power Commission*, 373 U.S. 294, 310 (1963), a rate should not be so "high as to deprive consumers, or so low as to deprive producers, of their right to a just and reasonable rate." The consumer is interested in the "lowest possible, reasonable rate consistent with the maintenance of adequate service" *Atlantic Refining Company v. Public Service Commission of New York*, 360 U.S. 378, 388 (1959). The producer is interested in recovering his cost and earning a reasonable return on his investment. The irreducible minimum rate permitted by this Court in the past has been one which allows all of the enterprise's legitimate expenses, one that covers the interest on its debt and pays dividends sufficient to continue to attract investors and retain a sufficient surplus to permit it to finance its operations, *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591, 603 (1944), *Colorado Interstate Gas Company v. Federal Power Commission*, 324 U.S. 581, 605 (1945). Obviously, a rate that would be too low for the producer to continue his operations

or one that would be too low to induce a producer to explore for above average cost gas would not be fair to the consumer because it would not provide an adequate supply of gas.

Although two separate ceiling rates were established, each one was fixed at the average cost level. The ceiling rate for flowing gas is the average cost of gas-well gas produced by 44 producers in the Permian Basin during 1960 from reserves added over the prior 20-30 or more years. It includes gas that cost 5.37¢ per Mcf and gas that cost 216.05¢ per Mcf.[4] It includes gas produced from the largest reservoir as well as gas produced from the smallest reservoir. It includes gas produced from the shallowest depth as well as gas from the deepest depth.

The ceiling rate for new gas-well gas is the *estimated* average cost of new gas-well gas to be produced from all reservoirs throughout the United States. The same rate is applicable to gas produced from a 10 trillion cubic foot reserve as from a 10 billion cubic foot reserve, to gas produced from a depth of 1,000 feet as from a depth of 20,000 feet, to gas that is to be depleted in 10 years as that which is to be depleted in 20 years, and to gas that cost 5¢ per Mcf as for gas that cost 30¢ per Mcf.

Whether or not a producer is able to recover his cost from flowing gas or from new gas-well gas depends upon the mix of gas that he happens to own or to discover. If a producer should own or discover only below average cost gas or even a preponderance of below average cost gas, the ceiling rate would provide him with a windfall. However, if a producer

[4] See Appendix I, Schedule 2, pages 71-72, *infra*.

should own or discover only above average cost gas or even a preponderance of above average cost gas, the ceiling rate would not generate sufficient revenues to reimburse him for his cost. Any method of regulation or rate design which depends upon the happenstance that a party would own just the right mix of a porduct with widely varying and uncontrollable unit cost does not make sense. The fact that it provides windfalls for parties producing about ½ of the product and provides the parties producing the other ½ little or no return even though such parties' unit costs are equal for comparable production makes even less sense. There are a number of very sound reasons why uniform ceiling rates are inequitable, unfair, unjust and unreasonable not only to the producer, but to the consumer as well.

1. *A Ceiling Rate Fixed At The Average Cost Level Will Not Permit The Producers In The Aggregate To Recover The Total Cost Actually Determined By The Commission.*

Unless a ceiling rate is fixed substantially in excess of the composite average cost, the revenues generated by such rate will not return total cost. An average is just that—an average. Likewise, a ceiling is a ceiling. One does not equate to the other. If average costs are to be validly compared with revenues, the comparison must be with average revenues. Obviously, if average revenues are to equate with average cost, there must be an offsetting with an above average rate for every below average rate.

By fixing the ceiling price at the composite average cost level, the Commission made it impossible for the producers

in the aggregate to recover total costs. The record shows that for flowing gas test year revenues (before any price reduction) fall short of the test year cost determined by the Commission. The average cost of 14.39¢ (R. 639d) is well in excess of the average revenue of 13.05¢ for gas-well gas and 12.72¢ for all gas (Staff Exhibit 175, Schedule 1, R. 538e).

Moreover, the average revenues will be further reduced by (1) ceiling rates and (2) quality adjustments. The ceiling rate is to apply to each separate rate schedule (R. 687d-689d) so that every price in excess of 14.5¢ must be reduced to 14.5¢. The rates for the gas that fails to meet the specified quality standards must be further reduced by an amount equal to the cost to the pipeline of bringing the gas up to the standard (R. 654d, 690d-691d). The minimum rate provision (R. 671d) and the partially upward BTU adjustment (R. 651d) will offset to some extent the downward adjustments. The Commission contends (Br. p. 96) that the revenues for old gas-well gas will average 12.9¢ per Mcf after all reductions and adjustments.[5] This does not appear to be reasonable since it is only .15¢ below the average gas well gas revenue of 13.05¢ (R. 538e) before any reduction. In any event the average revenue from the remainder of the flowing gas will be substantially lower than the 12.72 average (R. 538e) for all gas (including old gas-well gas) before any reduction or adjustment. Obviously the producers, as a group, can never recover the 14.39¢ average cost determined

[5] There is no record support for this contention. In fact, it was for this reason that the court below reversed the Commission (XII R. 46, 52, 54, 60-61).

by the Commission through rates that will generate something less than 12.9¢ average revenues.

2. *Uniform Ceiling Rates Fixed At A Level High Enough To Yield The Aggregate Industry Revenue Requirement Will Not Permit The Majority Of Producers To Recover Their Cost Even To The Extent Their Contracts Permit*

Increasing the ceiling rate to provide an overall industry revenue-cost balance will not remove the basic unfairness inherent in uniform, cost-based rates. The unfairness stems from the fact, as pointed out below, that the unit cost of gas is governed by the location in which nature placed it (the time of discovery and development, the rate at which it is produced, etc.) and not by the producer. Obviously, it is not fair to impose the same rate on gas that cost 20.0¢ per Mcf as that fixed for gas that cost only 10.0¢ per Mcf. By fixing ceiling rates for each separate gas rate schedule (gas sales contract) at the average composite cost level, no producer will be permitted to recover from any sale any part of its cost in excess of the average even though, as will be pointed out below, the owners of the below average cost gas will actually recover the above average cost incurred by the owners of such higher cost gas.

Although computed by using a 9½% rate of return instead of the 12% found appropriate by the Commission, and exclusive of state production tax, regulatory expense (R. 406d) and before any allowance for income tax, Staff Exhibits Nos. 174 (R. 499e-534e) and 329 (R. 1120e-1121e) clearly show that most producers will not recover their full cost. Actually the 14.5¢ rate would permit only 16 of the 44 producers whose

data was used to compute the old gas-well gas cost to recover the cost determined by the Commission.[6] But, the 14.5¢ rate will be eroded by quality adjustments and contract limitations to an average revenue of 12.9¢ per Mcf by the Commission's own admission (Brief p. 96), leaving only 10 of the 44 companies[7] with costs less than the average adjusted price.

Included in the 44 company group employed by the Commission are the 10 largest sellers of gas in 1961 and 19 of the 24 largest sellers.[8] Since the smaller companies as a rule, own higher unit cost gas than the larger companies, (2¢ per Mcf more for Appendix C producers than Appendix B producers (R. 1115, 539e)), it follows that only 10 to 16 of the 336 respondents (R. 529d) or the more than 1400 Permian Basin Producers (R. 223) will be permitted to recover their cost to the extent their contracts permit.

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[6] Although not a part of the official record, the Commission computed the old gas-well gas cost from data contained in the workpapers underlying schedule 3 of Staff witness Wright's Exhibit No. 170. Hunt, *et al.*, obtained the workpapers from Staff and checked the Commission's computations. Excerpts from Schedule 3 of Exhibit No. 170 (R. 429e, lines 14, 18 & 22 of Columns (2), (8), (9), (10)) together with the computation increasing as did the Commission, the return to 12% (and a tabulation of the data included in the excerpt by companies arrayed by costs from low to high) were reproduced as an appendix to their brief to the lower court. This data was referred to by the court below (XII R. 36, Note 24) and is reproduced as Appendix I to this brief for this Court's information. (Although the lower court was unable to verify it, we believe the accuracy of the data in the top half of Schedule 1, Columns 1, 2 and 3 of Schedule 2, of Appendix I is unassailable because the amounts tie into Schedule 3 of Exhibit 170 and no party has questioned any of the figures.) We also believe the accuracy of the other data to be just as defensible, although such data reflect computations from data contained in the workpapers, since no party has questioned these figures.

[7] The unit cost of the 44 producers ranges from a low of 5.37¢ to a high of 216.05¢ per Mcf.

[8] Federal Power Commission Sales by Producers of Natural Gas to Natural Gas Pipeline Companies, 1961, Table 6, Page 10.

3. Uniform Ceiling Rates At Average Composite Cost Levels Will Provide Windfalls For Some Producers

If, as the Commission and lower court held, cost is the proper measure of just and reasonable rates, a rate that is above cost will provide a windfall for the producer who owns such gas. Referring again to Appendix I, Schedule 2, Column 3, page 71 *infra*, it can readily be seen that the 14.5¢ price (ignoring quality adjustments) is in excess of the cost of 16 companies and below the cost of 28 companies; nevertheless, the 16 producers are authorized to charge 14.5¢ (assuming their contracts permit) regardless of their unit costs which range from 5.37¢ to 14.46¢ per Mcf. Thus, these producers are not only authorized to recover all of their cost, but are given a bonus by authorizing them to recover the portion of the cost in excess of 14.5¢ per Mcf which relates to the remaining producers whose costs range up to 216.05¢ per Mcf. These windfalls go to the producers owning less costly gas, which is generally gas from (a) reservoirs developed years ago, (b) shallow reservoirs, and (c) extra large volume reservoirs.

4. Uniform Ceiling Rates Require Consumers To Pay All Costs Incurred Whether 1¢ or $10 Per Mcf

Regardless of the unit cost of his gas, the producer must accept the price consumers are willing to pay. Thus in the absence of regulation, if gas cost $1.00 per Mcf and consumers are not willing to pay more than 20¢ per Mcf, the producers must stand the loss of 80¢ per Mcf. With regulation on an individual company basis, the producer would still have

to stand the loss because of his contract.[9] However, if regulation is on an area basis, and the price is fixed on the basis of average cost, the consumer must pay the additional 80¢ per Mcf. The absurdity of this is apparent when it is realized that the 80¢ does not go to the producer incurring the cost but to some other producer.[10]

Clearly any order

(a) that establishes rates on the sole basis of cost,

(b) that denies producers in the aggregate an opportunity to recover, through negotiated charges, the total costs incurred,

(c) that denies the majority of producers the right to recover their cost to the extent permitted by their contracts,

(d) that provides windfalls for some producers by authorizing them to recover all of their costs plus a portion of the costs incurred by others while denying such other producers the right to recover their cost,

(e) that requires consumers to reimburse one group of producers for costs incurred by another group,

(f) that requires consumers to pay substantially higher gas bills than would be necessary under an individual cost basis,

is unfair, unduly discriminatory, unjust and unreasonable in its consequences.

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[9] Producers are bound by their contracts, thus a producer cannot increase its rate above the rate provided for in the sales contract.

[10] There would be an estimated annual saving of $32,620,881 to the consumers of Permian Basin area gas under the individual company approach over the area approach. For an explanation of the estimate see Appendix I *infra*, pages 70-74.

B. *The Wide Variations In Unit Cost Among Different Categories Of Gas And Among Different Producers Make Uniform* Ceiling *Rates Fixed At* Average *Composite Cost Levels Unlawful* Per Se

Whether or not the average composite cost is the proper measure of the revenue requirements for the industry, a uniform ceiling rate fixed at such average composite cost level is unlawful *per se* because of the wide disparity of costs among different categories of gas as well as among different producers. Ironically, the Commission justified the imposition of uniform ceiling rates on an area group basis on this fact (R. 547d-549d). The opening and perhaps the principal argument of the Commission in support of uniform rates is summarized in its brief, pages 24, 25, as follows:

> "The record * * * shows that while producer costs vary widely from year to year on an individual-company basis, in the long run the cost of most producers tend to approximate the industry average. A uniform area rate based upon that average should, therefore, be fair to producers and consumers alike." (FPC Br. p. 24-25 also see Br. p. 55, 58).

Not only did the Examiner and Commission not make any such finding, but this conclusion and argument is contradicted by the Commission's own brief[11] and is contrary

[11] Excerpts from Commission Brief showing contradictions to quote:

"Like all prospecting, exploring for natural gas is a highly risky and uncertain business. The same investment may yield a dry hole, a marginal well, a moderately productive well, or a bonanza, depending upon luck as much, perhaps, as on extraordinary skill. Consequently, the variations in the cost of producing gas of identical quality are enormous. Not only do different producers tend to have different costs in any given year (R. 380e-416e, 493e-533e, 628e, 1014e-1022e), but an individual company's costs will often fluctuate widely from year to year (R. 771-773)." Footnote omitted. (Br. p. 51)

(Footnote continued on following page)

to all the evidence in the record, as well as positive findings of the Commission.[12]

If cost did in fact tend to "approximate the industry average" in the long run, the 1960 test year record would not have shown the wide variations in cost among producers because the test year gas was produced from reserves added over all prior years. Any "evening out" had to be reflected in the test year. An examination of the record (R. 771-773) cited (FPC Br. p. 55) for this proposition offers no support whatever to the argument. Only one component of cost, drilling and equipping wells, is considered, and this component is not reduced to cents per Mcf so that it is meaningless insofar as showing a trend in or comparison of unit cost. Moreover, as Staff Witness Wein pointed out (R. 774-775), the size of the area, the depth mix, and the "inherent variability in geological conditions over so large an area" (R. 775) account for the wide fluctuations in cost per foot. Thus, a producer in one year might drill in a very costly part of the area and the next year in a much less costly part. Therefore, this testimony is very strong evidence against uniform pricing.

(Footnote continued)

"But, since much of it [gas] was discovered in the past, when costs were lower, and some, indeed, was discovered when gas was a waste product (not even a marketable by-product), to price all gas at the higher current costs of gas-well gas would bestow a wholly gratuitous windfall upon producers." (Br. p. 87)

[12] The Commission actually found that: "An individual producer may find only dry holes or marginal wells or his search for gas may result in finding a huge new gas field. A price fixed by his individual cost experience could thus either be too high for consumers in relation to other available supplies or too low to be fair to the producer, considering his risks." (R. 547d)

"A single price based on future costs will result in windfalls to those producers who acquired and sold gas under lower cost conditions." (R. 565d)

It is self evident that a producer who first obtained gas production in 1956-1958 can never balance out his unit cost with the producer who has substantial production from reserves added prior to 1950 and especially prior to 1945 (R. 134d, 565d, 627d, FPC Br. p. 87). In approving or affirming the Commission in its uniform area ceiling pricing method, the lower court expressly recognized "that weighted averages and sifted averages are suspect" (XII R. 46) and grounded its ruling upon the assumption "that both the basic figures and the average obtained therefrom" are "typical and representative" (XII R. 46). The court below was imminently correct in principle, but grossly in error in assuming, contrary to the record, that the averages are typical and representative.

That average costs must be typical and representative to support uniform prices or rates was recently strongly reiterated by this Court in *Chicago and N.W. Ry. Company v. Atchison, T. & S.F. Ry. Company*, ... U.S. ..... 87 S. Ct. 1585, 1595 (1967) as follows:

> "The premise of group proceedings, as the New England Divisions Case explicitly recognized, is that evidence pertaining to a group is typical of its individual members, 261 U.S., at 196-199, 43 S. Ct., at 275-276. See also Beaumont, S. L. & W. R. Co. v. United States, 282 U.S. 74, 82-83, 51 S. Ct. 1, 4-5, 75 L. Ed. 221."

While the record does not permit a computation, we would expect that cost between producers of gas from the same or comparable reservoirs or fields would not vary too greatly. However, because of the mix of production of the various producers, the average unit cost of the gas does vary greatly

not only among different categories or classifications of gas, but among the producers.

Nature located gas in such a way as to preclude the composite average cost from being the typical or representative cost of all gas. Inflation over the years widened the gap between averages and the unit costs of producing various reservoirs of gas. The Commission did not find nor could it find on the record that the composite average unit cost of gas-well gas in the Permian Basin Area is typical or representative of the unit cost of any one or of all fields, of any one or of all reservoirs, of any one or of all depths, of any one or of all time periods, or of any one or of all producers.

1. *Wide Variations In Unit Costs Are An Inherent Characteristic Of Gas*

The wide variations in the unit cost of gas result, among other reasons, from: (a) time of discovery and development, (b) size of reservoirs, (c) rates of depletion or production, and (d) depths of producing horizons.

(a) *Time of Discovery and Development*—The average unit cost of gas added during the year 1958 was almost twice as much as that added in 1947 and earlier. The examiner found that the dollar cost of finding gas rose substantially between 1947-1960, 88% measured by producer witness Foster's indices and 61% measured by intervenor witness Joskow's indices (R. 134d). Although the Commission did not make a specific finding as to the increase in cost over the period 1947 or 1948 to 1960, it did not question the examiner's finding. The Commis-

sion did expressly hold, with respect to flowing gas, that unit costs were somewhat lower in the earlier years and leveled off in 1958 (R. 627d), that a single price based on future cost will result in windfalls to those producers who acquired and sold gas under lower cost conditions (R. 565d), and that the evidence of record indicates that costs have remained steady since 1960 and are likely to remain stable to 1968 (R. 661d-662d).

In determining the cost for new gas-well gas the Commission accepted the examiner's finding that cost per foot of drilling and equipping wells decreased 5.8% from 1958 to 1960 (R. 273d). Even after this reduction, the 1960 current cost of gas was found to be more than 2¢ per Mcf higher than the average cost of flowing gas produced from reserves added prior to 1960. Some 20 to 26% of the gas reserves were added prior to 1948 (R. 304d- 305d). [13] If as the examiner and the Commission found, cost (a) increased between 60 and 88% from 1947 to 1960, (b) decreased approximately 5% from 1958 to 1960, (c) was 16.43¢ per Mcf during 1960 (R. 615d) and (d) averaged only 14.39¢ per Mcf for the period from earliest production (20-26% of which dates prior to 1948), to 1960, (R. 639),

[13] Column 3 of the examiner's weighted average cost index tables shows that by using the Foster Estimated Reserves of gas added 16.7% was produced from reserves added prior to 1947 and 3.86 from reserves added during 1947 making a total of 20.56% produced from reserves added prior to 1948. Column 3 of the weighted average cost index prepared from witness Joskow's estimate shows that 26.1% of the gas produced during 1960 came from reserves added prior to 1948 (R. 304d-305d).

it is clear that the cost of 25% or more of the flowing gas produced from reserves added during the years 1957, 1958 and 1959 (R. 304d-305d),[14] when costs were at their peak, is substantially more than 2¢ per Mcf above the average unit cost of all flowing gas of 14.39¢

(b) *Size of Reservoirs*—As a general rule, unit cost decreases as volumes increase. If the total cost for each of two reservoirs is the same, but one contains twice the volume of the other, the unit cost of the smaller reservoir would be twice the unit cost of the larger reservoir. In this Permian Basin Area in the 1960 test year two fields produced 52.5% of the gas-well gas, 13 fields produced 76% of the gas, and the remaining 358 fields produced 24% of the gas-well gas (R. 1784).[15] While there is no way from this record to compute the unit cost of gas by fields, we can be virtually certain that the unit cost of the gas in the two fields producing 52.5% of the total is considerably less than the unit cost of the gas in the 358 fields producing only 24% of the total. It would be difficult indeed to conceive of any combination of circumstances that would result in higher unit

[14] According to the examiner's calculations, reserves added during the years 1957-1959 contributed 1960 test year production as follows:

Year	*Percentage Based on Foster Index*	*Percentage Based on Joskow Index*
1957	8.75	8.60
1958	8.00	9.23
1959	8.09	8.04
Total	24.84	25.87

[15] R. 1784, legal memorandum presented by the Texas Independent Producers and Royalty Owners Association at the request of the presiding examiner.

costs for the two largest fields than would be experienced in any of the 358 smaller fields. Surely this one fact alone compels a classification whereby the owners of the 358 fields can recover the cost actually incurred on an equitable basis with the owners of the two largest fields. Of course the uniform price would be most acceptable to those producers owning the largest fields because they would be permitted to recover much of the cost incurred by the owners of the 358 smaller fields.

(c) *Rates of Depletion or Production*—The rate of depletion is another important factor that materially affects unit cost. For example, if a reservoir of gas is produced or depleted in 10 years instead of the average 20-year or longer period, approximately one-half of the total operating costs would be saved. Thus, about one-half of the total operating expenses for a 20-year period would be spread over the total units of production, thereby reducing the unit operating cost by about one-half. Thus, under a 10-year depletion schedule, as compared to a 20-year schedule, the operating costs would be 1¢ v. 2¢, or 2¢ v. 4¢, or 4¢ v. 8¢ as the case might be. In addition, the return component would be reduced by approximately ½ since the investment would be recovered in 10 years instead of 20 or more years.

(d) *Depths Of Producing Reservoirs*—The cost data in this record relating to depth of production is generally limited to the cost per foot of drilling at different depths, the cost per well at different depths, total costs and related statistics. A reference to the tables

showing cost per foot for drilling wells to different depth intervals shows a sharp increase in cost per foot at depths of 10,000 feet and deeper (R. 52).[16] This does not measure the unit cost per Mcf as volume found has a marked influence upon the unit cost. However, the Commission justified in part its decision to fix a higher ceiling price for new gas-well gas on the fact that it would encourage exploration at deeper horizons directed toward finding gas (R. 569d). It is, therefore, clear that the depth factor must be made a part of the formula for pricing gas.[17]

2. *The Wide Variations In Unit Cost Among Producers Are The Result Of The Variations Inherent In The Unit Cost Of Gas*

Unit cost likewise varies greatly from producer to producer. This variation results from the fact that all producers do not have the same mixture of gas. It would be a rare coincidence to find two producers who happen to have just the right mix of gas to give both producers the same average unit cost. That there are, in fact, great differences in cost

[16] For drilling cost per foot of Permian Basin respondents in the Permian Basin Area and the Continental United States for depth intervals of 2501'-3750', 5001'-7500', and 10,001'-12,500' see tables 21 and 22 of Exhibit 166, (R. 400e-401e).

[17] A recent Federal Power Commission publication "The Gas Supplies of Interstate Natural Gas Pipeline Companies—Calendar Years 1964 and 1965", Table 4, page 5 shows that 24% of the dedicated reserves are from depths of 0-5000 feet, 62% (65% of gas-well gas) are from depths of 10,000 feet or shallower. Since it costs three times as much per foot to drill from 15,000-17,500 as it does from 10,000 feet or less (R. 52), a producer must find at least three times as much gas per well at the deeper depths for the same unit drilling cost.

between producers is recognized by the Commission and the court below. In Opinion No. 468 the Commission said:

> " * * * A price fixed by his individual cost experience could thus either be too high for consumers in relation to other available supplies or too low to be fair to the producer, considering his risks." (R. 547d)
>
> " * * * individual returns will vary greatly, but this is as it should be, provided that profits in the aggregate are at a reasonable level." (R. 548d)
>
> "The individual company approach would also result in a wide variety of rates in a single field, and even for the sales by co-owners from a single well, depending on their varying company-wide costs." (R. 549d)

The court below noted that:

> "The uncertainty of the business causes substantial cost and revenue fluctuations not only from producer to producer but also from year to year for the same producer. A regulated commodity, gas, is produced in substantial quantities along with an unregulated commodity, oil. The allocation of costs between them baffles the experts and presents the temptation to use mathematical means of arriving at a predetermined result. The same rate may bring a financial windfall to one producer and a financial disaster to another." (XII R. 31)
>
> " * * * no area rate, whether based on composite costs, average aggregate costs or any other industry wide criteria, will suffice to assure a high cost producer of its costs to say nothing of a profit. We accept this as true. [footnote omitted] The impact of an area rate in the natural-gas industry may have effects which cover the entire range from bonanza to bankruptcy." (XII R. 35-36)

The magnitude of the difference in costs among producers is indicated by the Commission Staff witness Wright's array Exhibits Nos. 174[18] and 329.[19] Although Staff did not present these figures for the purpose of determining the propriety of the rates of any one company (R. 1143), and although they may not show the full costs, they do show the wide dispersion of cost between producers. Exhibit No. 329 shows that gas-well gas costs range from 2.9¢ per Mcf to 170.5¢ per Mcf for producers with annual jurisdictional sales of 10 million Mcf or more and from 3.8¢ to 134.5¢ per Mcf for Appendix B producers having jurisdictional sales of less than 10 million Mcf per year. (R. 1120e-1121e). Witness Wright in Exhibit No. 174 arrays various cost components to show the range in cost for all Appendix B producers[20] by component and type of gas. They are summarized as follows:

	Cents per Mcf			
Cost Component	*Gas-Well Gas*	*Oil-Well Gas*	*Total Raw Gas (Gas Well & Oil Well)*	*Record Ref.*
Cash Expense Only	.0 to 17.16	.86 to 9.81	.0 to 9.81	R. 505e-510e
D D & A only[21]	.0 to 113.70	.12 to 10.31	.12 to 17.84	R. 511e-516e
E & D Only[22]	.0 to 12.8	.0 to 8.9	.0 to 8.9	R. 517e-522e
Return Allowance	.11 to 160.84	.04 to 11.63	.04 to 102.81	R. 523e-528e
Total of Above Components	2.9 to 170.5	5.9 to 20.7	4.0 to 122.6	R. 499e-504e

Clearly then any price fixed without analyzing and considering the differences in the unit cost of gas itself as well

[18] R. 499e-534e

[19] R. 1120e-1121e

[20] Actually Exhibit No. 329 separates the total Raw Gas data of Exhibit No. 174 between producers with annual jurisdictional sales of 10 million Mcf or more and those with less than 10 million Mcf.

[21] Depreciation, Depletion and Amortization

[22] Exploration and Development

as the difference in the average unit cost of gas owned by the various producers violates Section 4(a) of the Natural Gas Act requiring all rates to be just and reasonable and the Constitutional prohibition (Amendment V) against taking one's property without due process of law. The injury is compounded here by arbitrarily fixing *ceiling* rates at *average* cost levels.

C. *Uniform Ceiling Rates Are A Deterrent Instead Of An Incentive And Will Not Assure The Maintenance Of An Adequate Gas Supply*

Uniform rates by their very nature are deterrents rather than incentives. True the uniform ceiling rate of 16.5¢ fixed for new gas offers more incentive than the 14.5¢ rate fixed for old gas. But, the fact remains that the 16.5¢ ceiling is at the average composite cost level. Thus, instead of providing an incentive to explore for increasing amounts of gas, it sets the brake at the 16.5¢ cost level. This, of course, is the converse of what the Commission intended.

The Commission justified its adoption of the two-price system on the findings that "new gas discoveries are the life blood of the industry and are also essential to consumers who are tied to natural gas." (568d); that an incentive price is required to induce the producers to continue exploration (R. 563d-569d); that a single price for all gas "fixed low enough to reflect cost for old gas" (between 14.5 & 16.5¢)[23] would not assure adequate supplies (R. 566d); and that

[23] Such price, would have to fall between 14.5 and 16.5¢ if the average unit composite costs actually determined by the Commission are correct.

"the producers inducement to engage in further exploration and development directed toward gas comes from the knowledge that future gas supplies will receive a price which provides adequate compensation." (R. 566d)

If, as the Commission found, an incentive is required for producers to engage in further exploration and development, and if that inducement, as the Commission also found, is the "knowledge that future gas supplies will receive a price which provides adequate compensation" (R. 566d), uniform *ceiling* rates at *average* composite cost levels are not the answer. It is self evident that the average cost is somewhere near the middle. It is below the cost of approximately ½ of the gas and materially below the cost of a substantial portion of the gas. Where then is the inducement to explore for above average cost gas? There is none. Nor can there ever be. No prudent operator large or small is going to knowingly spend 20¢ per Mcf for gas and sell it for 15.0¢ or 16.0¢ per Mcf. As distributor witness Kahn testified, whether or not producers invest money in the search for gas "depends upon the prospect of profit in the future." (R. 537)

Moreover, regardless of expert testimony, theories, administrative feasibility, or the findings of the Commission and the courts, the fact still remains that the location by nature of natural gas is such that the unit cost of capturing it varies substantially from reservoir to reservoir. And higher costs are not going to be knowingly incurred unless a higher price is authorized.

The Commission found that "consumers and the natural gas industry alike have a strong stake in the continuation of the exploration efforts of the thousands of small operators, who contribute a large share of the discoveries of new sources of gas" (R. 677d). The smaller producers are faced with a higher risk than the larger producers, *Phillips Petroleum Company*, 24 FPC 537, 569. The higher risk merits a higher return (R. 599d, 606d, XII R. 54), and the cost of small producers is higher than the cost of the large producers (R. 1114-15). Yet these are the very producers who will receive little or no return.

The industry as such does not drill wells; only individual producers drill gas wells. In the final analysis the question of the adequacy of supply cannot be divorced from the individual producers. Thus, if there is to be an incentive, it must be to the individual producer.

As pointed out in Section B1(b) (p. 36 above) about 75% of the gas-well gas in Permian Basin is produced from a few large fields, the remaining 25% being produced from the multitude of small fields. If this 25% of the gas is important and necessary to assure an adequate supply to the consumer and if, as the Commission found, there is a growing need (R. 568d) for gas, the price fixed must take into account small reservoirs, deep reservoirs, and the small, deep reservoirs. Common sense assures us that no company, large or small, is going to knowingly explore for and find gas that will cost more than the price allowed by the Commission. It's as simple as that. If the higher cost gas is needed, a price higher than the average must be allowed.

D. *Uniform Ceiling Rates Will Not Reduce The Administrative Burden*

Uniform ceiling rates will not solve the problem of administrative feasibility which is one of the major reasons, if not the principal reason, given by the Commission for abandoning the individual company cost-of-service method of regulation and adopting the two-price system on an area group basis, *Phillips Petroleum Company*, 24 FPC 537, 545-546 (1960), Commission Br. p. 54, (R. 546d-549d).

In the first place the administrative burden of regulating producers on an individual company basis is not nearly as great as it might appear. According to a recent press release, there are 127 natural gas pipeline companies subject to the Commission's regulation [24] whereas only 69 independent producers were directed to complete the All Areas Questionnaire for 1962[25] which was designed to collect volume, cost, and revenue data on an industry-wide basis for area rate proceedings. The data of only 44 producers was used to fix the ceiling rate in this case. It would therefore appear that once standards and rules are established, there would be less difficulties regulating producers than pipeline companies on an individual company basis as long as cost data is restricted to the larger producers.

[24] Press Release No. 15093, G-8960 issued August 28, 1967.

[25] Letter notice of March 17, 1964, relating to the Commission's letter order of October 30, 1963, 30 FPC 1155, which directed all producers making sales of more than 10,000,000 Mcf annually in interstate commerce to complete and file the questionnaire, 31 FPC 34 (January 9, 1964). The October 30, 1963, order as modified also directed natural gas pipeline companies, and natural gas pipeline affiliates making sales of more than 10,000,000 Mcf annually to complete and file the questionnaire.

While the area group method might seem to accomplish the purpose of simplifying the regulation of independent producers, initially, the gain, if any, will be short lived. In fact, the problem will be severely aggravated by the adoption of the two-price system. Although, admitting it could not bind future commissions (R. 569d), the Commission expressly stated that the new gas price, if it were to achieve its purpose, must be firm for the life of the gas reserves (R. 569d). What happens then 3, 5, or 6 years later when the area rate for flowing gas must be redetermined? How will the Commission separate the data between old gas-well gas and new gas-well gas in such a way as to arrive at reasonable costs? Unless the Commission at that time resorts to some kind of classification of the gas by time periods, which is one of the things we are suggesting should have been done in the first place, there would be no way by which the Commission could separate the data between the gas-well gas included at the 14.5¢ rate and the gas-well gas priced at the 16.5¢ rate. In addition, the new gas that has been certificated between the time the 16.5¢ rate was fixed and the time the next area rate proceeding is instituted, may well have a different average composite unit cost than the 16.5¢ cost determined for 1960, thus the Commission will have (1) the problem of costing the gas-well gas for the period 1960 and prior, (2) the problem of determining the cut off date for the 16.5¢ rate, and (3) the problem of segregating the data for gas-well gas for each of these three periods. At that time it will be necessary to determine a new gas-well gas cost or a current gas-well gas cost. Thus, in

the next round there will be a minimum of 4 uniform ceiling prices.

It must also be remembered that the cost of old gas-well gas is used as the standard for pricing all oil well gas, old and new. Somewhere along the line the old gas-well gas may play out, and there will be no standard available for pricing the oil well gas. In any event, there will be the problem of knowing which vintage of gas-well gas to use for pricing which batch of oil well gas.

With all of these problems to be faced at the beginning of the second round of area rates, there can be no justification on the grounds of administrative feasibility for adopting the two-price system over the individual company cost-of-service or over some kind of classification of gas itself. We submit that no weight should be given to administrative feasibility as a justification for affirming the Commission.

E. ***Ceiling Rates At Average Cost Levels Have Not And Cannot Accommodate The Peculiar Characteristics Of The Natural Gas Producing Industry***

As the Commission held,

> "Both the constitutional and the statutory questions, in other words, are not to be decided abstractly, but rather in the light of the nature of the specific rate-making problem involved, and of what is required to achieve a sensible result. The necessity for accommodating the system of regulation to the circumstances of the industry being regulated was recognized by the Supreme Court in the *Nebbia* case, *supra*, in which it was held that due process under the Fifth and Fourteenth

> Amendents demand only that government regulation 'shall not be unreasonable, arbitrary or capricious, and that the means selected shall have a real and substantial relation to the object sought to be attained' (P. 525)." (R. 546d-547d)

The Commission then gave six reasons for adopting uniform rates on an area group basis to accommodate the peculiar characteristics of the gas producing industry. But, as is pointed out below, uniform ceiling rates do not and cannot attain the goals stated by the Commission because such rates are not compatible with the peculiar characteristics of the natural gas producing industry.

(1) *Basic to the area approach is the fact that "objective cost standards for fixing just and reasonable rates for producers' sales can best be developed by examining overall producer experience." (R. 547d).*

Regardless of whether this statement is true, the Commission, instead of examining and analyzing the overall producer experience in the various reservoirs, fields, depths, and time periods, arbitrarily and capriciously and without citing any evidence or giving any logical reason for doing so, merely added up costs and divided such total cost by the volumes to obtain what it called an average composite cost. For flowing gas the data of only 44 producers was used, and for new gas-well gas a wide variety of data from governmental and private agencies was used. This cannot be said to be an objective standard in any sense of the word.

(2) *On a group basis, costs and rates can be developed which will be fair to all concerned (R. 547d-548d).*

Among the many reasons why uniform ceiling rates at average composite cost levels are not fair are the following:

(a) A producer's rates are fixed on the basis of other producers' cost without even considering whether the group costs are typical or representative of the cost of the gas or the cost of the producers.

(b) A producer who sells only pipeline quality gas and has an average cost of 14.5¢ per Mcf and average revenue of 14.5¢ per Mcf will be required to reduce the price of every rate schedule with prices above 14.5¢ to the 14.5¢ ceiling. Thus, such producer's revenue will be reduced below cost even though such producer's cost is not above the average cost found to be just and reasonable by the Commission.

(c) Uniform ceiling rates at average composite cost levels authorize the owners of below average cost gas to recover their full cost (contracts permitting) plus the cost of the gas in excess of the average incurred by owners of above average cost gas. Just as no producer is entitled to a subsidy with consumers' money (R. 658d), no producer is entitled to recover cost incurred by other producers.

(d) Some producers receive windfalls while other producers are denied the right to recover their cost.

(e) Where two producers jointly own above average cost gas, one co-owner is authorized to recover his

full cost by substitution, i.e., he collects excessive rates from his below average cost gas to offset the loss on the above average cost gas, whereas, the other co-owner is not only not authorized to recover his full cost but is not even allowed his contract rate because it is the only gas he has.

(f) The exploration allowance of 4.08¢ per Mcf is given to all producers indiscriminately regardless of whether a producer's exploration cost is zero or 20.0¢ per Mcf.

(g) It's not fair to the consumer to fix ceiling rates at a level that will discourage exploration for above average cost gas because such gas is necessary for the maintenance of an adequate supply.

(h) It's not fair to require consumers to reimburse one group of producers for costs incurred by another group of producers.

(i) It's not fair to fix rates on the basis of cost without first considering all of the factors affecting the cost.

(3) *A uniform pricing system is adapted to the economics of the natural gas industry (R. 548).*

As has been pointed out in Section B above, this simply is not true because of the inherent characteristics of gas. The Commission supports this statement with two truisms: (a) the producer who finds large reserves will achieve greater profits than the producer whose exploration efforts result in dry holes or marginal wells, and (b) the producer

whose enterprise is conducted with efficiency and economy will make more money than the producer who runs his business poorly. While both of these statements are true, they are not peculiar to the gas industry. As we have seen, uniform rates are not adapted to the economics of the gas industry, since variations in the unit cost of gas are inherent in the gas itself without regard to the efficiency of the producers.

(4) *The area price will give producers the incentive they need to explore to meet the nation's increasing demand for gas (R. 548d).*

As has been pointed out in Section C, a uniform ceiling price at the average composite cost level cannot provide an incentive to explore for above average cost gas. On the contrary, such a price is actually a deterrent to exploration.

(5) *The area approach will eliminate the administrative bottleneck (R. 548d-549d).*

While this might appear to be true initially, the method actually used by the Commission cannot help but complicate cost determinations in the future. (See Section D, pages 44-46.) Had the Commission gathered the data by reservoirs, time periods, depths, and volume categories, various classifications could have been made here and utilized in later proceedings for facilitating future cost determinations. However, the determination of rates on an area group basis cannot be a great timesaver over the individual company cost-of-service method because the Commission must record the individual company cost data in its electronic machines in order to obtain area data. Once proper

standards are established and computer programs prepared, the machines could for all practical purposes compute cost on an individual company basis, within the same time required for an overall basis. Certainly there wouldn't be over a day or two's difference. True, some additional analysis of individual company data would be necessary to correct for test year abnormalities, but this should not require any great length of time once everyone understood the standards and the rules.

(6) *The individual company approach would also result in a wide variety of rates in a single field, and even for the sales of co-owners from a single well depending on their varying company-wide costs (R. 549d).*

While this is true in one sense, it is not true in a real sense because the cost of gas from a single well is the same for all co-owners. The apparent difference comes about by the costs that are more or less arbitrarily allocated to the well. Exploration and development costs, and general and district overhead costs are allocated to the various leases by highly controversial formulas. Thus, on an area basis every producer's exploration and development cost and overhead is added together and allocated uniformly without regard to the actualities. On an individual company cost-of-service basis a producer who did not spend any money in exploratory activities would not have any exploration expense to allocate, whereas, producers who were actively engaged in exploration might have 5, 6 or 7¢ per Mcf to allocate to gas. For the Permian Basin producers, exploration costs range from 0 to 8.9¢ per Mcf for the total raw gas and from 0 to 12.8¢ for gas-well gas (R. 517e-520e). This one component

alone which averaged 4.08¢ per Mcf (R. 639d) accounts for the major part of the varying cost of gas from the same well.

The Commission, instead of adapting its regulation to take this peculiarity into account, ignores it and avoids the issue by arbitrarily allocating the same unit cost to every producer's gas. This, of course, denies the producer who actually explored for gas the right to recover his cost while at the same time permitting the producer who did not spend any money for exploration to recover such cost. This certainly is not a fair way to even up the cost.

It is clear from the reasons given that the Commission has succumbed to the "temptation to use mathematical means of arriving at a predetermined result." (XII R. 31).

F. *The Variations In Cost Must Be Reflected In The Rates If They Are To Be Adapted To the Peculiar Characteristics Of The Gas Producing Industry*

As the lower court held, "It is self evident that when average costs are used to compute ceiling prices, the high-cost operator will be hurt and some low-cost operators may receive windfalls" (XII R. 46-47). Despite this accepted fact and the recognition "that weighted averages and sifted [sic] averages are suspect" and the fact that it accepted "the principle that both the basic figures and the averages obtained therefrom must be typical and representative" (XII R. 46), and the further recognition that "superficially it seems unfair to fix ceiling prices for all producers, both large and small, on the basis of the costs of large producers only (XII R. 49), the lower court affirmed the Commission

in fixing uniform ceiling rates at the average composite unit cost levels.

As justification for this contradiction or inconsistency, the court cited this Court's decision in *Acker v. United States*, 298 U.S. 426, 431, (1936) wherein it was held that "regulation cannot be frustrated by a requirement that the rate be made to compensate extravagant or unnecessary costs." (XII R. 47). It is clear from *Acker* and the other cases cited that the basis for the court's affirmance was the fact that it believed the cost in excess of the average to be extravagant, unnecessary or unreasonable or imprudently incurred. Nothing could be further from the truth as is evident from the discussion and record citations in Section B above.[26] Moreover, the Commission negated any such implication by including all of the above average cost along with the below average cost in its computation and fixing uniform ceiling rates at a level designed to require consumers to pay all such cost.

The only way to avoid "unfair and unjust consequences", *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591, 602, of a rate order which is based on the sole criterion of cost is to reflect substantial cost variations in the rate structure.

The Commission argues, Br. p. 29, that "in a real sense, new gas-well gas is worth more to consumers, not because it is better gas, but because the higher price is necessary to insure an adequate supply for the future." A higher price

[26] The Commission recognized this when it stated that gas that costs 40¢ per Mcf, though not necessarily imprudent, is not worth 40¢ to the consumer (FPC Br. p. 52).

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is necessary to assure an adequate supply of gas; but if the price is to assure the adequate supply, it must be higher for higher cost gas than for lower cost gas. Likewise, the higher cost flowing gas is worth more to the consumer than the lower cost gas, not because it is better gas, but because the higher price is necessary to make the owners of such gas whole in order that they may continue their exploration and development.

That cost was the sole criterion or measure for the rate levels fixed is evident from the Commission holding that "there is no justification in this area for any adjustment of a cost determined ceiling price" (R. 614d). Moreover, the Commission actually rounded off to the nearest ½¢ the composite average cost determined for the two classifications of gas—the average composite cost of 16.43¢ for new gas-well gas was rounded off to 16.5¢ (R. 615d) and the average composite cost of 14.39¢ of old gas-well gas was rounded off to 14.5¢ (R. 639d, 645d).

This record, as pointed out above, clearly shows wide variations of costs, all of which were held, at least impliedly, to have been prudently incurred. But, the Commission gave absolutely no consideration to the need for fixing rates that would provide an extra allowance for the gas that actually cost more. On the contrary the Commission expressly held that any consideration of differences in cost between producers would defeat the whole purpose of area pricing (547d-549d). The lower court upheld the Commission on this point stating that once "the whole group is split the process

can be carried on until the regulation is back on an individual company basis." (XII R. 49).

The only consideration given by the Commission for adjusting the price above or below the average composite cost level was: (1) the impact of the prescribed rate on existing rate structures, (2) the quality of the gas in the area, (3) the historical prices in the area, (4) the location factor, and (5) the gold standard factor (R. 613d). None of these, of course, have any bearing upon the economics of producing gas,[27] nor the characteristics inherent in the unit cost of gas itself, nor for that matter the differences in cost of the gas owned by different producers. But as noted above, the Commission held that these factors did not justify any adjustment of a cost-determined ceiling price (R. 613d-614d).

Moreover, the Commission designed the data-gathering questionnaires (Appendices A, B & C) in such a way as to preclude costing gas by different classifications, that is as to time of discovery and development, size of reservoirs, annual production, and depths, and denied producers the right to introduce evidence to show the inequities and unreasonableness of uniform rates among the producers themselves.[28]

We have already shown the more than 2¢ difference in unit cost of flowing gas resulting from time of discovery and development (pages 34-36), the effect of volume on unit cost (pages 36-37), the effect of rate of production on

[27] Quality of the gas bears on the economics of producing gas in the sense that it costs an additional amount to upgrade its quality, but quality as well as location and gold standard are more correctly classified as value factors. Value and cost, of course, are entirely different concepts.

[28] Order issued April 5, 1961, (R. 29d, 32d) as modified by order issued May 14, 1962, (R. 66d, 68d).

unit cost (page 37), the fact that depth has a great impact on unit cost (pages 37-38), and the fact that the unit cost of producers varies greatly, as well as the magnitude of those variations (pages 38-41). In addition Staff witness Wright testified that the unit cost of the small (Appendix C) producers[29] was 2¢ per Mcf more than the unit cost of large (Appendix B) producers (R. 1114-1115).

This Court recently reaffirmed the accepted principle of rate design that gives effect to different costs. *Chicago & N.W. Ry. Co. v. Atchison T. & S.F. Ry. Co.*, ... *U.S.*....., 87 S. Ct. 1585, 1591-2, 1599-1603 (1967). There this Court stated that "the Commission devised a special divisional scale, adapted to the particular circumstances of the case and designed to produce * * * increases * * * found justified by the evidence relating to cost of service." (87 S. Ct. at p. 1602) "The commission has frequently used such scales in the past * * * Under the system adopted, the mileage contributed is broken down into 50-mile blocks * * * A large number is assigned the first block, and a smaller number to successive 50-mile increments; this is designed to reflect terminal and standby costs incurred regardless of the length of carriage contributed." (87 S. Ct. at p. 1591)

The only conceivable fair alternative to considering the various factors that affect the unit cost level of gas produced from various fields at different depths and from reserves added in different time periods or the average cost of various

[29] Producers with annual jurisdictional gas sales of less than 10 million Mcf were given the option of completing Appendix B or an abbreviated questionnaire designated as Appendix C (R. 629d). The Appendix C data was not used by the Commission (R. 630d).

producers is to fix a price at a level that would allow the producers of at least 75% of the total volumes produced to recover their cost plus the allowed return.[30]

There is no evidence in this record to show unlawful discrimination in a varied rate structure, and "it is clear that mere differences in rates under this act are not *per se* unlawful." *Wisconsin v. Federal Power Commission*, 373 U.S. 294, 307 (1963). On the contrary all of the evidence shows rank discrimination for different categories of gas and among different producers unless a varied rate structure is established. Therefore, it is only fair to permit the producers to collect their contract rates or cost, whichever is lower.

[30] See Staff Witness Wein's testimony (R. 776-778). The Commission Staff later recommended this procedure in the South Louisiana area rate hearing, as the following extract of evidence shows:

"19. Q. Please explain how you arrived at the 1.25¢ Mcf differential between the average cost and the revenue standard?

A. The average unit cost as developed by Mr. Engel represents the volumetrically weighted average unit costs incurred by each of the 81 respondents included in the staff's cost analysis. This average cost probably covers the total cost of approximately 50% of the volumes produced. In addition, it is a fact that a range of costs exists which would probably show that some of the gas is produced at very low cost and some of the gas is produced at a cost which is so excessive that no reasonable rate level would be sufficient to cover its total cost. Therefore, a price which will cover the total cost of only approximately 50% of the volumes produced would give insufficient consideration to the total cost of the other 50% of the volumes.

In my judgment a price which covers the total cost of 70-80% of the volumes rather than 50% would constitute adequate coverage and a ceiling rate related to volumes approximating 75% would be reasonable. In arriving at this judgment and to arrive at a judgment as to an appropriate differential, I examined the cost arrays * * * "(Additional direct testimony of staff witness Joseph Bombino, Tr. p. 24, 605, lines 6-23, South Louisiana Area Rate Proceeding, Docket No. AR61-2, *et al.*)

G. *Uniform Ceiling Rates Are Not A Panacea Nor Is There A Basis In Fact, Custom Or Law For Imposing Uniform Cost-Based Ceiling Rates On Producers*

Each of the several reasons given by the Commission for adopting a two-price system rather than a single-price system are even stronger arguments against uniform ceiling rates. They, as pointed out below, clearly show that uniform rates do not and cannot meet the statutory and constitutional requirements.

(1) *The ability to direct exploration effort toward finding gas-well gas as distinguished from finding gas as a by-product in the search for oil (R. 563d).*

Coupled with this ability is the ability to evaluate prospects so that those prospects which are expected to cost more than the average will be passed up.

(2) *A single price based on an average of historical and current cost even if it yielded the same revenue cannot provide the same incentive (R. 565d).*

(3) *One price would offer no assurance that producers would make investments to bring forth adequate new supplies of gas (R 566d).*

While the 16.5¢ new gas-well gas rate offers more incentive than a lesser rate (the average of 14.5¢ and 16.5¢), it cannot offer any incentive to explore for gas that cost more than 16.5¢. If, for example, a single price of 15.5¢ will not provide the assurance of needed investments, the additional one

cent cannot be expected to do the job when about half the gas that could be found would still cost more than the 16.5¢ per Mcf ceiling rate.

(4) *A single price based on future cost will result in windfalls to those producers who acquired and sold gas under lower cost conditions (R. 565d, 566d).*

If the difference of about 1¢ per Mcf[21] will result in unlawful windfalls, the much greater difference in cost of flowing gas among producers [118.6¢ for total raw gas (122.6¢-4.0¢, R. 499e-500e), and 167.6¢ for gas-well gas (170.5¢-2.9¢, R. 501e-502e)] would certainly compel some form of classification or formula that would reflect the variations in cost.

(5) *The producers' inducement to engage in further exploration and development directed toward gas comes from the knowledge that future supplies will receive a price which provides adequate compensation (R. 566d).*

(6) *"In the absence of a regulatory pattern which offers encouragement for the search for gas there is no guarantee that the present generally satisfactory pace of exploration will continue, much less increase to meet growing demands." (R. 568d)*

Obviously, a ceiling price fixed at the average cost level, instead of providing the knowledge that future supplies will receive "adequate compensation," provide the opposite, *i.e.*, the knowledge that the above average cost supplies *will not*

[21] The average of historical cost (14.5¢) and current cost (16.5¢) would be around 15.5¢ or 1¢ above the historical average.

"receive a price which provides adequate compensation." So there is no inducement nor encouragement. On the contrary, a ceiling at average cost levels will discourage exploration.

(7) "The future needs of the gas market can no longer be satisfied by the incidental discoveries in the search for oil." (R. 569d)

If the future needs cannot be met by incidental discoveries whether in the search for oil or lower cost gas, something more than ceiling rates at average cost levels must be offered explorers.

While uniform ceiling rates for each well, for each reservoir, or even for all wells or all reservoirs having comparable unit cost makes a great deal of sense, there is no basis in fact or law for fixing uniform ceiling rates at average cost levels for all gas for all producers in an area.

Gas sales contracts usually provide for a term of 20 to 22 years. Producers must accept whatever prices they can negotiate regardless of cost. The commodity value at the time of the sale governs the price that can be obtained. The volume of gas available for sale and the cost of other fuels, the location of the gas with respect to the market, and the quality affect the commodity value. The time of discovery and development, the volumes found, the depth at which it is found and the rate at which it is produced affect the cost. But, the below cost contracts must be balanced out with above cost contracts if the producer is to remain in business. Regardless of the cost or the increase in commodity value, the producer can never charge more than his

contract permits. Yet, the Commission has imposed uniform ceiling rates at average cost levels *contract* by *contract*. Thus, only the producers who own below average cost gas with contract prices equal to the ceiling rate are permitted to balance low cost against higher cost gas.

The Commission has never and does not now, except for this case, fix or permit uniform rates when there are substantial variations in cost. Even in this case, the two-price system was adopted to accommodate a 2.0¢ per Mcf differential in cost,[32] but the much greater differential in cost within each of the two categories of gas[33] was completely ignored.

On August 30, 1965, (25 days after fixing uniform rates for all producers regardless of differences in costs) the Commission in Opinion 471, *Michigan Wisconsin Pipe Line Company*, 34 FPC 621, held that uniform rates for all customers of one pipeline are inappropriate [citing *Northern Natural Gas Co.*, 14 FPC 11 (1955), affirmed 236 F. 2d 372 (CA 8) *certiorari denied*, 352 U.S. 967] on the ground "* * * that the varying distances between the customers and sources of gas resulted in different transmission costs and that it was discriminatory to have those relatively close to the source of gas, shoulder the transmission costs of customers far from the source." 34 FPC at p. 624.

[32] The Commission determined the average cost of new gas to be 16.43¢ per Mcf and fixed the ceiling rate at 16.5¢ (R. 615d). The cost of old gas was determined to be 14.39¢ (R. 639d) and the ceiling rate was fixed at 14.50¢ per Mcf (R. 645d).

[33] (R. 499e-502e); Appendix I, pages 71-72, *infra;* and pages 34-41, *supra*..

Moreover, two years after enlarging the issues in the *Hugoton-Anadarko Area Rate Proceeding* to include pipeline gas production along with independent producers' gas production on an area basis, the Commission severed the pipeline gas production issue because of the alleged cost differential.[34]

The pipelines are not only permitted but required to charge varying rates for the different classes of service. Some of the differences are:

(a) Transportation charges are based upon the pipeline company's individual cost-of-service, *Michigan Wisconsin Pipe Line Company*, Opinion No. 471, 34 FPC 621, 625 (1965).

(b) Gas storage charges are based on each company's cost which varies greatly. The variation in cost to the pipeline

[34] The pipeline production issue was consolidated with the *Hugoton-Anadarko Area Rate Proceeding*, Docket No. AR64-1, *et al.*, by order issued June 29, 1964, 31 FPC 1595. By motion dated December 30, 1965, the Commission Staff requested the Commission to sever the pipeline producing companies from the area proceeding and gave among other reasons the following:

"* * *the threshold question of whether the Commission should switch to an area rate method of pricing pipeline production will be largely determined by the impact of such a change in regulatory policy on each *individual* pipeline. Furthermore, this impact on each pipeline must be determined by comparing its total aggregate companywide cost of production with the total dollars of imputed purchased gas expense which would result from the application of the area rates * * *"

The Commission, by order issued April 13, 1966, 35 FPC 497, granted Staff's motion stating: "no evidence has been introduced upon which a determination could be made of the impact upon the consumers of the various pipelines of substituting an area rate for one based upon each company's individual costs * * *" and "that much of the production in the area is of low cost, with the result that on a historic cost of service basis, it is significantly lower in cost than the nationwide cost of service for all gas" 35 FPC at page 498.

companies for 1964 (though not necessarily the variation in charges to the customer) are summarized below.[35]

Area	*No. of Companies*	*Average Cost ¢ per Mcf*	*Range Between Companies ¢ per Mcf*
Eastern Area	15	18.65	4.49 to 34.02
Midwestern Area	14	14.53	1.01 to 83.31
Western Area	3	9.31	7.95 to 33.60
Southern Area	1	19.73	19.73
All Areas	33	16.97	1.01 to 83.31

(c) The pipeline tariffs approved by the Commission provide for different rates for different classes of service and for different volumes. Small volume sales are generally priced higher than large volume sales.

(d) Different pipelines charge the same customers different prices.

(e) As recently as August 10, 1967, the Commission authorized El Paso Natural Gas Company to increase its purchases from West Coast Transmission Company, Ltd., from 300 million to 500 million cubic feet per day on condition that the uniform price of 27¢ per Mcf advocated by the parties be replaced by continuing the 22¢ per Mcf rate for 300 million cubic feet per day in accordance with a pre-existing contract and charging 29.5¢ per Mcf for the additional 200 million Mcf per day. *El Paso Natural Gas Company*, Opinion No. 526, Memo page 1, 2, 17, 18. Since delivery and measurement are at the Canadian border, delivery of the 500 million

[35] Commission Press Release No. 14108, G-7965, issued November 16, 1965, which is reproduced as Appendix II, p. 75, *infra*, to this brief.

cubic feet per day would be from a common stream and would of necessity be of the same quality from the same seller to the same purchaser.

Moreover, the price per identical units is almost without exception less when sold and delivered in large volumes. For example, bicycles, refrigerators, potatoes, meat, shoes, etc., are always available for a lower unit cost when bought in carload lots. Likewise, the transportation rates are always cheaper in carload and truckload shipments than for broken lots or individual units.

There is probably no other business, whether it be one which furnishes services or one which sells commodities, in which volume has as great an effect on unit cost as gas. Therefore, any logical, reasonable and fair rate design taking into account the peculiarities of the industry and tailored to the natural gas producing industry must give effect to such factors.

Furthermore, no sane person would suggest that uniform ceiling rates at average composite cost levels be imposed upon area or nationwide gas distributors, pipeline transporters, construction companies, road building companies, bridge builders, etc. Just as the differences in unit cost of furnishing the same service must be reflected in the rates of the company that performs the service, differences in the unit cost of gas must be reflected in the rates to the producers who make the gas available.

It defies all logic

(1) to assume that uniform ceiling rates fixed at the average composite cost levels are fair, just and reasonable for all gas,

(a) when the actual cost of some gas is much lower than the average, and the actual cost of other gas is much higher than the average,

(b) when the bulk or all of the gas owned by some producers costs less than the average, and the bulk or all of the gas owned by other producers costs more than the average, and

(2) to assume that any producer would knowingly explore for gas that was expected to cost more than the average, when he knows for a certainty that regardless of the cost, the price permitted by the Commission will not exceed the average cost of all gas.

H. *Special Relief, Even If Modified To The Extent Held Necessary By The Lower Court, Will Not Provide Just And Reasonable Rates*

The Commission made provision for producers with special circumstances to petition for special exception to the area rates (R. 656d-660d), but as the lower court held, "the Commission's exemption provisions are so vague and nebulous that neither they, nor a court, can determine what relief is being granted." (XII R. 51). Special provisions, even if modified to correct defects pointed out by the lower court, will not resolve the problem for a number of reasons.

First, the special circumstances, if they could be called that, are not special circumstances of the producer, but rather of the gas, as was pointed out in Section B above (pages 34 to 41). The reasons for some gas costing more than the average are beyond the control of the producer. Moreover, most all producers have some above average cost gas. The problem is that some producers do not have enough, if any, below average cost gas in an area to offset the above average cost gas.[36] So the problem of these unfortunate producers cannot be appropriately resolved in an individual company special relief petition when producers are being regulated on an area basis.

Second, should this Court affirm the Commission's method of fixing uniform ceiling rates at average composite cost levels, no producer would be able to meet the heavy burden of convincing the Commission that an exception should be made in his case on the grounds (1) that his production was discovered and developed during a period in which costs were at their peak, (2) that the volumes found were insufficient to result in a lower average unit cost, or (3) that the particular field or reservoir from which the production is obtained is of such a nature as to result in above average unit cost. This is true because the Commission recognized that all these factors were involved and inherent in the natural gas business, but refused to recognize the need to consider them or the impact that they have on individual producers.

Third, a special relief hearing would be futile to virtually every producer that needed it. About the only evidence

[36] This could be due solely to late entry of the producer in the area.

these producers could present would be a showing that their average unit cost is higher than their average unit revenue, but the Commission has already said that this is not a justification for higher rates. These producers would not have the means or the legal power required to gather area-wide data in a manner to permit the computation of unit cost by time periods, volumes, reservoirs, fields, or any other classification in order to show that their gas cost no more than the below average producers' gas cost in the same or comparable fields. The Commission has refused to gather data in such a way as to permit such a showing.[37]

Fourth, even if the Commission should grant a producer a special exception and permit a rate for some gas higher than the ceiling rate, such relief would be restricted to flowing gas. Thus, while it might avoid confiscation of flowing gas, the relief could not aid a producer in securing above average prices for new gas because the ceiling prices set by the Commission would be the maximum prices any producer could obtain for new gas (R. 678d). As Commissioner O'Connor said, "if the maximum price any one producer can obtain from his production is insufficient, as he might determine *vis-a-vis* his own interest and alternative investments, it is of little concern to him that the ceiling was premised on the larger percentage of the industry's cost. So long as there is a reasonable likelihood that his prices will be reduced below his contract terms or his certificate conditions, he will not have the necessary incentive to commit funds for further exploration" (R. 704d).

[37] *Area Rate Proceeding, et al. (Hugoton-Anardarko Area)*. Docket No. AR64-1; *Area Rate Proceeding, et al.* (Texas Gulf Coast Area), Docket No. AR64-2, Order issued August 27, 1965, 34 FPC 609, and order issued October 21, 1965, 34 FPC 1180.

Fifth, in the light of the above four reasons and the fact that the Commission expressly stated that any special price relief above composite average unit costs would be limited to out of pocket expenses (whatever that means) or abandonment, and the fact that the lower court ruled that no producer has a right to continue exploration and development (XII R. 49), the special relief, even as modified by the court below, is, as a practical matter, tantamount to liquidation. This does not meet the objectives of the Act which are to assure just and reasonable rates for all gas and to assure consumers of the lowest reasonable rate consistent with the maintenance of adequate service. Therefore, the Commission should not be allowed to squeeze out the producers who happen not to have sufficient below average cost gas to offset their above average cost gas.

II.

CONCLUSION

The judgment of the court below and the opinion of the Commission should be set aside and modified to the extent necessary to provide either

(1) A rate structure that will reflect to a reasonable degree the variations in the actual cost of gas on some logical classification consistent with the uncontrollable cost characteristics such as time of discovery and development, volumes, and depth, or

(2) A rate structure that will reflect to a reasonable degree the variations in cost of gas among the producers, or

(3) To revert back to an individual company-wide cost-of-service method in order that each producer may balance high-cost gas against low-cost gas.

Respectfully submitted,

PLACID OIL COMPANY

Paul W. Hicks
Attorney

Appendix I
Schedule 1

AR61-1

Excerpts from Staff Witness Fisher Exhibit #170 Schedule 3
(R. 429e)

(1)	Volume (2)	Cash (3)	D.D.&A. (4)	Return 9.5 (5)	Total (6)
Gas Only	41,652,569	914,606	1,358,618	2,260,225	4,533,449
Lease Sep.	165,562,676	2,707,133	3,643,021	5,916,674	12,266,828
No Lease	1,271,495	30,120	38,762	59,894	128,776
Total	208,486,740	3,651,859	5,040,401	8,236,793	16,929,053
Total (Return at 12%)	208,486,740	3,651,859	5,040,401	10,403,070	19,095,330
Unit Costs		1.75	2.42	4.99	9.16 (1)

Hunt, et al., Computation

Exploration Cost	4.08¢	(2)	
Regulatory Expense	.14	(2)	
State Production Tax	1.01	(2)	
	5.23¢ per Mcf times 208,486,740 Mcf equals		10,903,857
Total Cost of Gas Well Gas			29,999,187
Total Cost to be Recovered under Individual Company Approach			24,779,846 (3)
Additional Cost to Consumers for Gas Well Gas Alone (16% of total)			5,219,341
Conversion Factor			6.25 (4)
Total Additional Cost to Consumer of Permian Basin Gas under Area Approach			32,620,881

(1) Cost per Opinion No. 468, page 85 (R. 634d)
(2) Cost per Opinion No. 468, page 89 (R. 639d)
(3) Column (5) of Schedule 2
(4) See Appendix A, Schedule 3 for computation of this factor

Appendix I
Schedule 2

AR61-1
Array of Gas Well Gas
Costs (Excluding Combination Gas Well Gas); Unit Revenues;
and Computation of Total Cost to be Recovered under
Individual Company Approach

Line No.	Company Name (1)	Total Volume (2)	Total Unit Cost Including 1.15¢ Tax & Reg. Exp. (3)	Unit Revenue (4)	Lower of Cost at 12% or Rev. (5)
1	General Amer. Oil Co. of Tex.	414,943	5.37	14.50 1/	$ 22,282
2	Geo. S. Hammonds	5,063,624	5.50	7.33	278,499
3	Cities Service Petroleum	3,327,621	8.97	11.41	298,488
4	Neville G. Penrose, Inc.	596,477	9.99	9.59	57,202
5	Tidewater Oil Co.	3,166,277	10.16	15.43	321,694
6	Amerada Petroleum Corp.	4,334,492	10.89	10.78	467,258
7	Pure Oil Co.	5,276,717	11.28	12.43	595,214
8	Standard Oil Co. of Texas	21,136,362	12.69	11.37	2,403,204
9	Pan American Petroleum Corp.	12,127,048	12.71	15.56	1,541,348
10	Gulf Oil Corp.	26,541,853	12.98	11.54	3,062,930
11	Phillips Petroleum Corp.	49,903,669	13.12	11.78	5,878,652
12	Humble Oil & Refining	18,034,596	13.15	14.70	2,371,549
13	Sunray DX Oil Co.	1,166,157	13.21	12.72	148,335
14	Shell Oil Company	13,317,166	13.28	13.38	1,768,520
15	Delhi-Taylor Oil Corp.	140,307	13.47	10.85	15,223
16	Continental Oil Co.	8,015,818	14.46	12.80	1,026,025
17	Blanco Oil Co.	1,490,394	14.77	10.69	159,323
18	Western Nat. Gas Co.	5,788,945	15.75	14.45	836,503
19	Ohio Oil Company	1,285,367	15.92	11.30	145,246
20	Skelly Oil Company	5,042,000	16.91	14.80	746,216
21	Atlantic Refining Co.	5,601,840	17.06	12.34	691,267
22	Texas Pacific Coal & Oil Co.	968,360	17.43	7.78	75,338
23	Honolulu Oil Corp.	363,842	17.62	9.77	35,547
24	Three States Nat. Gas Co.	86,303	17.52	8.80	7,595
25	Anderson-Pritchard Oil Corp.	1,579,246	18.47	12.43 1/	196,300
26	Midwest Oil Corp.	36,356	19.04	14.50 1/	5,272
27	Forest Oil Corp.	35,865	19.56	12.36	4,433
28	Sinclair Oil & Gas Co.	3,391,492	19.62	11.18	379,169
29	Julian E. Simon	55,750	22.33	10.00	5,575
30	Texaco, Inc.	2,571,461	22.81	12.92	332,233
31	Aztec Oil & Gas Co.	362,359	25.14	10.34	37,468
32	Jake L. Hamon	33,801	27.98	6.90	2,332
33	British Amer. Oil Prod. Co.	1,203,548	29.23	15.83	190,522
34	Sun Oil Company	1,074,250	34.63	13.57	145,776
35	Cosden Petroleum Corp.	466,459	35.80	12.60	58,774
36	Cities Service Prod. Co.	586,833	36.62	5.88	34,506
37	Socony Mobil Oil Co.	3,366,976	50.40	10.56	355,553
38	Santa Rosa Gas Co.	30,576	58.37	7.07	2,162
39	Union Oil Co. of California	344,367	60.25	15.40	53,032

Appendix I
Schedule 2,
Page 2

Line No.	Company Name (1)	Total Volume (2)	Total Unit Cost Including 1.15¢ Tax &Reg. Exp. (3)	Unit Revenue (4)	Lower of Cost at 12% or Rev. (5)
40	Superior Oil Co.	68,667	96.46	14.50 1/	9,957
41	El Paso Natural Gas Products	47,078	139.46	14.50 1/	6,826
42	Northern Nat. Gas Prod. Co.	32,877	151.36	16.28	5,352
43	Sohio Oil Company	1,211	189.65	6.11	74
44	Cabot Oil Co.	7,390	216.05	14.50 1/	1,072
	Total	208,486,740			$24,779,846

1/ Stated at 14.5¢ since Gas Well Gas revenues are not readily available.

Source: Workpapers underlying Staff Witness Fisher Exhibit #170.

Appendix I
Schedule 3

COMPUTATION OF PERCENTAGE OF GAS COSTED
BY THE COMMISSION

Volumes Produced by 44 Appendix B Producers
Per Staff Exhibit 170, Schedule 2

Gas Only	41,652,569 Mcf	4.21%
Gas Condensate (Lease Separation)	165,562,676 Mcf	16.74%
Gas Condensate (No Lease Separation)	1,271,495 Mcf	.13%
Sub-Total (Volumes Utilized By Commission)	208,486,740 Mcf	21.08%
Combination Leases	245,446,436 Mcf	24.83%
Oil Casinghead	527,546,398 Mcf	53.37%
Oil Only	7,076,472 Mcf	.72%
TOTAL	988,556,046 Mcf	100.00%

Volumes Produced by all Permian Basin Producers Per
Exhibit 18 Together with Computation of Percentage
Of Total Volumes Used by Commission in Fixing Price of all Flowing Gas

Net Working Interest Volume Of 44 Appendix B Producers Estimated To Be .875	988.556 Bcf
8/8 Volume (988,556,046 ÷ .875)	1,129.778 Bcf
8/8 Production From Exhibit 18, Schedule 1, Golumn F, Line 6	1,482.600 Bcf
% Of Total Permian Basin Production Included In Exhibit 170, Schedule 2 (1,129.778 ÷ 1,482.600)	76.2%
% Of Total Permian Basin Gas Costed By The Commission In Opinion 468 (76.2% x 21.08%)	16.0%
6.25 x 16.0% equals	100.00%

Appendix I

Explanatory Statement of Estimate of Additional Cost to Consumers Under the Area Group Approach Over The Individual Company Approach

The Commission determined the total production and development costs for the three classifications of gas leases* to be $19,095,330 (Schedule 1). Exploration cost was computed to be 4.08¢ per Mcf, regulatory expense .14¢ per Mcf and severance tax, 1.01¢ per Mcf (Opinion 468, page 89) (R. 639d). By multiplication these costs are computed to be $10,903,857, (Schedule 1), therefore, total cost under the area approach amounts to $29,999,187 (Schedule 1) compared to $24,779,846 (Schedule 2) if costs and prices had been computed on an individual company basis. The difference is $5,219,341 (Schedule 1).

Since gas-well gas from the three gas leases represented only 16% of the total Permian Basin gas production (Schedule 3) the additional total annual cost to the consumer in Permian Basin alone due to the area approach would be 6.25 (100% ÷ by 16%) times the difference of $5,219,341 or $32,620,881 (Schedule 1).

* Gas only, gas condensate with lease separation and gas condensate without lease separation, Opinion 468, Appendix C, pages 1 and 2 (R. 810d-811d).

Appendix II

Table 2

ESTIMATED COST TO STORE GAS UNDERGROUND BY PIPELINE COMPANIES IN 1964

Area of Storage Operations	Number of Fields Fields Being Tested	Number of Fields Fields Not Tested	Number of Fields Total	Average MCF Injected and Withdrawn (1)	Depreciated Storage Plant Investment (2)	15% of Depreciated Storage Plant Investment 15%x(2)=(3)	Storage Operating And Maintenance Exp. (4)	Total Cost of Storing Gas (3)+(4)=(5)	Cost Per MCF (Cents) (5)÷(1)=(6)
Eastern Area									
Atlantic Seaboard Corporation	3		3	12,385,879	$ 25,159,389	$ 3,773,358	$ 441,118	$ 4,214,476	34.02
Home Gas Company	3		3	5,441,137	9,404,776	1,410,716	189,083	1,599,804	29.41
Manufacturers Light and Heat Company	10		10	34,746,158	52,184,363	7,827,654	1,681,999	9,509,653	27.37
Pope Natural Gas Company	2		2	27,614,009	36,723,589	5,508,538	994,253	6,502,791	23.55
Iroquois Gas Corporation	3		3	16,556,977	17,377,899	2,606,685	842,938	3,449,623	20.83
Pennsylvania Gas Company	10		10	6,308,053	7,116,887	1,067,533	232,804	1,300,337	20.62
Equitable Gas Company	8		8	26,901,600	32,631,928	4,894,789	803,482	5,698,271	21.18
Tennessee Gas Transmission Company	7	1	8	17,675,745	16,348,709	2,452,306	747,279	3,199,585	18.10
Texas Eastern Transmission Corporation	16		16	34,456,309	26,581,366	3,987,205	2,335,398	6,322,603	18.35
Transcontinental Gas Pipe Line Corporation	2	1	3	28,672,212	29,278,173	4,391,726	696,912	5,088,638	17.74
Ohio Fuel Gas Company	16	1	17	87,837,879	72,118,695	10,817,804	3,431,408	14,249,212	16.22
United Natural Gas Co. & The Sylvania Corp.	14	10	24	12,084,759	8,379,501	1,256,933	818,196	2,075,127	16.11
New York State Natural Gas Corporation	14	10	24	84,128,214	73,500,960	11,025,144	2,343,431	13,368,575	15.89
United Fuel Gas Company	15	15	30	52,006,561	40,027,720	6,004,160	1,678,766	7,682,926	14.77
North Penn Gas Company	2	2	4	6,420,309	6,955,192	943,688	144,582	288,270	4.49
Subtotal	100	7	108	456,035,703	447,780,187	67,167,028	17,872,751	85,038,779	18.65
Midwestern Area									
Mississippi River Transmission Corporation	1	1	2	235,132	1,184,299	177,645	19,075	196,720	83.71
Texas Gas Transmission Corporation	9	6	15	10,856,146	19,789,383	2,968,407	777,842	3,746,249	34.50
Natural Gas Pipe Line Co. of America	7	5	12	23,143,348	45,479,927	6,771,989	1,086,746	7,858,735	33.93
Panhandle Eastern Pipe Line Company	1	3	4	9,738,680	16,155,693	2,423,354	639,349	3,062,703	31.45
Northern Natural Gas Company	1	3	4	31,390,521	32,051,124	4,807,669	925,170	5,732,839	18.26
Lone-Nebraska Natural Gas Company, Inc.	2	3	5	4,983,048	3,455,083	518,262	104,362	622,624	12.49
Montana-Dakota Utilities Company	3	3	6	9,558,752	6,018,894	902,834	80,296	983,130	10.29
Michigan Gas Storage Company	3	3	6	32,492,842	35,957,855	2,393,678	732,577	3,126,255	9.62
Arkansas Louisiana Gas Company	5	5	10	2,843,908	1,124,926	168,737	35,162	204,899	8.04
Michigan Wisconsin Pipe Line Company	9	1	10	59,878,232	556,753	83,513	4,742,255	4,825,768	8.06
Union Gas System, Inc.	5	5	10	3,561,227	14,207,757	2,131,164	35,948	2,167,112	60.85
Cities Service Gas Company	10	10	20	39,905,757	10,638	1,596	647,929	649,525	1.63
Fort Smith Gas Corporation	2	2	4	678,395			5,845	5,845	0.86
Midwestern Gas Transmission Corporation	2		2						
Subtotal	85	62	147	225,671,943	152,992,322	22,946,848	9,830,956	32,779,804	14.53
Western Area									
Mountain Fuel Supply Company	1	1	2	596,080	1,005,066	150,760	49,506	200,266	33.60
Lone Star Gas Company	6	7	13	23,114,218	10,954,712	1,643,207	440,760	2,083,967	9.02
El Paso Natural Gas Company	1	2	3	5,530,462	1,083,077	156,461	285,940	442,401	7.95
Subtotal	7	10	17	29,240,749	13,002,855	1,950,428	773,206	2,723,634	9.31
Southern Area									
United Gas Pipe Line Company	20	15	35	4,022,986	4,903,989	735,598	58,026	793,624	19.73
Total	212	101	313	714,970,381	$618,679,353	$92,801,902	$28,533,939	$121,335,841	16.97

1/ Estimated annual plant costs.
2/ Includes only fractional interests owned by this pipeline company.
3/ Includes also fractional interests owned by this pipeline company.
4/ All facilities and combination gas leased from non-jurisdictional affiliate, Michigan Consolidated Gas Company.
5/ Fields being tested but not in operation.

PETITIONER'S BRIEF

OCT 9 1967

JOHN F. DAVIS, CLERK

NOS. 90, 95, 98-102, 105, 117, 181

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1967

THE PERMIAN BASIN AREA RATE CASES

On Writs of Certiorari to The United States Court of Appeals for the Tenth Circuit

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BRIEF FOR THE STATES OF NEW MEXICO AND TEXAS

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BRIEF FOR THE STATES OF NEW MEXICO AND TEXAS

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Tenth Circuit, issued on January 20, 1967 (XII R. 12-61),[1] and its per curiam opinion and order on

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[1]The record in this Court consists of fourteen volumes, thirteen of which constituted the joint appendix in the Court of Appeals. Volumes I-V, which contain only testimony before the Commission, are paginated 1-1908 (botton of page) and will be cited "R. 1-R. 1908." Volumes VI-VIII, which contain exhibits presented during the hearings, are paginated 1e-1146e and will be cited "R. 1e-R. 1146e." Volumes IX-XI, which contain pleadings, orders, and opinions in the Commission proceedings, are paginated 1d-1157d and will be cited "R. 1d-R. 1156d." Volume XII (the only tan-covered volume), which includes the decision of the Court of Appeals and other items from the file in the court below, is numbered 190 and will be cited "XII R. 1-90." There are also two small volumes —a supplement to the joint appendix below paginated 1s-40s, and a table of contents for Volumes I-XI.

rehearing, issued on April 18, 1967 (XII R. 87-9), are reported at 375 F.2d 6 (10th Cir. 1967). The Federal Power Commission's Opinion and Order Determining Just and Reasonable Rates for Natural Gas Producers in the Permian Basin, Docket No. AR61-1, et al. (Opinion No. 468), the related Order Issuing Certificates, and the related Order to Show Cause issued on August 5, 1965 (R. 516d-838d, 37s-40s), are reported at 34 FPC 159, 418, and 424 respectively; and its Opinion and Order Denying Applications for Rehearing of Opinion No. 468, Docket No. AR61-1, et al. (Opinion No. 468-A), issued on October 4, 1965 (R. 1105d-1136d), are reported at 34 FPC 1068. The initial decision of the Presiding Examiner, issued on September 17, 1964 (R. 97d-364d), is reported at 34 FPC 306.

JURISDICTION

The judgment of the Court of Appeals remanding the opinions and orders of the Federal Power Commission was entered on January 20, 1967. The per curiam opinion and order of the Court of Appeals denying rehearing was entered on April 18, 1967. The States of New Mexico and Texas, petitioners herein, did not petition for rehearing before the Court of Appeals. A petition for a writ of certiorari was filed on April 17, 1967. The petition for a writ of certiorari was granted on June 12, 1967. 26 U.S.L. Week 3437 (U.S. June 13, 1967) (No. 1291, 1966 Term; renumbered No. 98, 1967 Term).

The jurisdiction of this Court is invoked under the provisions of 28 U.S.C. 1254(1) and Section 19(b) of the Natural Gas Act.[2]

[2]Act of June 21, 1938, c. 556, § 19, 52 Stat. 831, as amended 15 U.S.C. 717r (1958).

QUESTIONS PRESENTED

1. Whether the Federal Power Commission, in fixing producer rates under the Natural Gas Act, is required to protect the public interest of producer states as well as consumer states?

2. Whether the Federal Power Commission, in fixing producer rates under the Natural Gas Act, is required to consider the economic impact of its orders on the producing states involved?

3. Whether the Federal Power Commission, in fixing producer rates under the Natural Gas Act, is required to consider the impact of its orders on the conservation efforts of the producing states, ie. whether its orders will result in waste of recoverable natural gas reserves.

4. Whether the Federal Power Commission, in fixing producer rates under the Natural Gas Act, is required to make an express finding that the rates established by its orders will elicit a level of exploration and development high enough to assure an adequate supply of natural gas for the future.

STATUTES INVOLVED

The pertinent provisions of the Natural Gas Act, 15 U.S.C. § 717-717w, are reproduced in the Appendix of the Brief for the Federal Power Commission, which has been filed, and is incorporated herein by reference.

STATEMENT

The Court has before it in this Permian Basin Case the landmark case that can very well decide the fate of the *Interstate Gas Market* for future generations.

This is the most important Commission decision to reach appellate review since this Court charged the Commission with the duty to regulate producer prices in *Phillips Petroleum* v. *Wisconsin,* 347 U.S. 672 (1954).

Hence, the States of New Mexico and Texas are particularly desirous that the Court resolve the questions presented above for future as well as present guidance to all concerned.

ARGUMENT

POINT I

The Federal Power Commission is required by the Natural Gas Act and the Constitution of the United States to consider the public interest of producing states as well as consumer states.

While the States of New Mexico and Texas do not drill or operate any gas wells in the Permian Basin or elsewhere and cannot therefore be deprived by the Commission of the opportunity to recover a "just and reasonable rate", they neverthless have challenged the rates established by the Commission because of the adverse effect of the same upon the public interest of these producing states. In fact these Petitioners are in all probability more adversely affected by these orders than any other parties to this proceeding as will be shown below.

There are many communities in the State of New Mexico which depend heavily on the oil and gas industry for their existence, and accordingly the State has an abiding interest in maintaining the future

existence of this industry. Without the oil and gas industry, a quarter of New Mexico's population would vanish and be forever lost.

More than one million Texans live in the Permian Basin area today, and, without a healthy petroleum industry, this population cannot be supported.

Testimony of witnesses for New Mexico and Texas reflects that the Permian Basin area does not readily lend itself to manufacturing, and the majority of manufacturing in the area is tied to the petroleum industry. Agriculture in the area is mostly confined to ranching, and even if the climate were more favorable, agriculture could not provide the jobs afforded by the petroleum industry.

Thus it can be seen that the States of New Mexico and Texas are not just interested bystanders in these proceedings. The very existence of their public educational system is at stake. More than forty-five percent (45%) of New Mexico's school support is derived directly from the oil and gas industry and without it the State could not possibly sustain this burden.

The Commission failed to meet its statutory responsibilities to protect the interest of the public. In the Natural Gas Act (15 U.S.C.A. Section 717(a):

> ". . . it is declared that the business of transporting and selling natural gas for ultimate distribution to the public is affective with a *public interest,* and that Federal regulation in matters relating to the transportation of natural gas and the sale thereof in interstate and foreign commerce is necessary in the *public interest.*" (Emphasis added)

These Petitioners maintain that the term "public

interest" includes producing states as well as consumer states and that the Commission is required to consider the effect of its order and opinions upon producing states as well as upon consumer states. The interest of producing states is a part of the "public interest" and should not be ignored.

It is not contended that the Commission's action in this case is unlawful simply because it adversely affects the States of New Mexico and Texas. Nor do these states seek the crumbs from a feasting table of the gas companies. They do, however, seek a just and reasonable rate, arrived at by the Commission, after considering all aspects of the public interest including the interest of the public in the producing states. This the Commission has failed to do, and the Tenth Circuit Court of Appeals has sustained the Commission in its position, citing as the authority for doing so the case of *Federal Power Commission* v. *Hope Natural Gas Company,* 320 U.S. 591. It is this aspect of the *Hope* Case that these Petitioners ask the Court to reconsider in light of the distinctions between the facts in that case and those in the instant case, which distinctions are more particularly set out in a later portion of this brief.

In view of the tremendous impact that producer rate regulation has upon the producing states, it is incredulous that Congress either could or would exclude the interests of these states and their citizens from the Commission's determination of the "public interest". To do so would amount to "interval colonialism"—the subjugation of one group of states in the Union to the interests of another.

If conscience alone would not proscribe such a policy,

surely the Equal Protection Clause of the Constitution would do so.

POINT II

The Natural Gas Act and the Constitution of the United States require the Commission to consider the economic impact of its orders and rates upon the producing states.

The State of Texas has over 4.7 million acres of minerals located in the Permian Basin area. The income, royalties and bonus money from these minerals go into the Permanent School Fund for educational purposes. Likewise, the State of New Mexico owns more than 3 million acres of mineral lands located within the Permian Basin, and the royalties and bonus money derived from these minerals go into its school fund.

New Mexico and Texas have imposed certain taxes upon the production of natural gas within their boundaries. This is done in recognition of the fact that natural gas like other natural resources is a wasting asset, and once produced and transported to other states for consumption, its value is forever lost. This tax is calculated upon the value of the gas at the well, and it is axiomatic that any reduction in its value will necessarily result in a reduction of the taxes received by these Petitioners.

Prior to the advent of gas producer price regulations by the Commission, its other regulatory activities had a relatively insignificant impact upon the various producing States throughout the country. Since that time, however, the Commission's impact on both the economy and conservation efforts of the producing States has

multiplied in ever increasing degrees. Finally this trend has culminated, through the instant case, in a disastrous wellhead rate reduction throughout a vast area of New Mexico and Texas known as the Permian Basin.

In one fell stroke the Commission would artifically reduce by untold millions of dollars the value of the real estate (mineral royalties) of the sovereign States of New Mexico and Texas.

Again we would reiterate our position that the Commission's Orders and rates in this case are invalid, not as a result of the adverse economic impact upon the producing states, but rather because the Commission and the Court below failed and refused to even consider this aspect of the case by virtue of this Court's language in the *Hope* Case.

POINT III

The Natural Gas Act requires the Commission to consider the impact of its orders and rates on the conservation policies of the producing states.

The Natural Gas Act of 1938, 15 U.S.C.A. § 117(a)-117(w) expressly provides for the cooperation between the Federal Power Commission and State conservation commissions. It says specifically:

> "The Commission is authorized in the administration of this act to avail itself of such cooperation, services, records, and facilities as may be afforded by any State commission."

In view of this provision in the law, the testimony offered by the Chairman of the Texas Railroad Com-

mission, William J. Murray, Jr., is particularly important. He pointed out that both the states and the nation have a vital interest in the preservation and utilization of the large volumes of casinghead gas found in the Permian Basin Area. Commissioner Murray said that he desired to call to the attention of the Federal Power Commission certain conservation problems which are normal in the production of casinghead gas and which would worsen, to the detriment of the consumer and conservation, if area rates are too low or discriminatory as compared to similar gas well gas. (R. 1394).

Witness Murray said that the conservation efforts of the Railroad Commission of Texas have resulted in saving 15 trillion cubic feet of gas equal in energy to 2½ billion barrels of oil, within the last decade alone. (R. 1397). He said that if a separate ceiling is established for casinghead gas materially lower than that for gas well gas, such pricing would injure continued conservation of this type of natural gas. (R. 1397).

Furthermore, materially lower rates can result in the premature abandonment of many "stripper fields" in New Mexico and Texas, whereupon the remaining reserves in these fields would be wasted and forever lost to both producers and consumers.

In the early days of the oil and gas industry most casinghead gas was vented to the atmosphere and flared because the price of gas was so low that it did not justify the cost of gathering and marketing. Over the years the price of such gas slowly increased and finally reached a level which did justify its salvage. Even then, however, most oil companies were reluctant to make the investment necessary to gather, compress

and market casinghead gas. It was only after several years of insistence by the various producing State Conservation Agencies that substantial quantities of this type of gas reached the market place, the results of these States' Conservation efforts are monumental. Today, the bulk of the gas sold in interstate commerce from the Permian Basin consists of casinghead gas.

The Commission in its Opinion and Order in the instant case assumes that this source of gas will continue to be available to the interstate market irrespective of price, since casinghead gas by definition is gas produced incidental to the production of oil. This assumption is invalid. It costs a substantial amount of money to equip, install and operate a casinghead gas gathering system and the producing companies are simply not going to do so at a loss. Nor can the state conservation agencies require that this gas be salvaged unless it is economically feasible to do so. The Commission's order in this case could substantially interfere with the conservation efforts of New Mexico and Texas and result in the wasting of vast quantities of preciously needed supplies of natural gas. If the commodity value of casinghead gas, when compared with competitive fuels, were not sufficient to justify its salvage, such waste would be unavoidable. This is not the case however. Current contract prices, the best evidence of commodity value, are sufficiently high to justify salvage. It is only the arbitrary ceiling prices established by the Commission in this case that would compel such a result.

These petitioners submit that the legislative and judicial mandate on the Commission to secure to the consumer the "lowest reasonable rate" was never

meant or intended to compel the wholesale wasting of the nation's natural gas resources. The public interest cannot so be served.

The Legislatures of both the States of New Mexico and Texas long ago enacted comprehensive oil and gas Conservations Codes. These codes are strenuously enforced by the Conservation Commission of New Mexico and the Texas Railroad Commission, both highly respected administrative agencies which have under their combined charge and supervision the greater part of the known natural gas reserves in the United States. The successes that they achieve in preventing waste are enjoyed not only by their respective States but by the entire nation. The efforts of these agencies are truly in the public interest—the interest of all the public, not just one faction.

Thus a conflict has arisen between the efforts of the Federal Power Commission and the Conservation Agencies of the States of New Mexico and Texas. This is true despite the fact that the agencies on both sides of this conflict have as their stated purpose the protection of the "public interest".

It is submitted that the public has a greater interest in the conservation of the nation's natural gas reserves than it does in promulgating the lowest possible ga[redacted] rates to the consumer, and that if and when these public policies should come into conflict the latter [redacted] give way to the former.

The Commission likewise totally failed and refused to consider the impact of its orders on the conservation policies of the producing states on the ground that this was not a matter for their concern.

Again The Tenth Circuit Court of Appeals sustained the Commission's position, saying:

> "The states of Texas and New Mexico, besides adopting the briefs and arguments of the Continental Group, assail the Commission decision on grounds peculiar to them in their governmental capacity. They say that the public interest, which the commission is required to protect, includes the producing states as well as the consuming states; that the prices which the Commission has set will cause a cessation or curtailment of exploration and development activities to the serious injury of the economy of the Permian Basin; *that waste rather than conservation of a natural resource will result;* and that the states and their public entities will suffer severe losses in taxes and royalty payments. Similar arguments were made by West Virginia in Federal Power Commission v. Hope Natural Gas Company, 320 U.S. 591, 607-614, and were rejected by the Supreme Court which said that when Congress passed the Natural Gas Act it 'was quite aware of the interests of the producing states in their natural gas supplies' and that nothing in the Act intimates that high prices should be maintained so that 'the producing states obtain indirect benefits.' The rejection of the state's contentions in Hope requires the rejection of the same contentions here."

Granted that West Virginia's argument in the *Hope* case is in some respects similar to the position taken by the States of Texas and New Mexico in the Permian case now before the Court, the *Hope* case is nevertheless distinguishable on its facts and cannot serve as a precedent in this case.

The *Hope* case arose from an original complaint filed in 1938 by two consumer cities alleging that Hope's

charges were excessive and "unjust and unreasonable". *Hope was primarily an interstate transporter and marketer of natural gas.*

The *Hope* case was decided in January of 1944, ten years before Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672, which pronounced the Federal Power Commission's jurisdiction to set the price of gas at the wellhead.

In the *Hope* case the Supreme Court was reviewing the order of the Commission in fixing the rate of return and cost of service for one interstate pipeline company and not the the wellhead price for gas to producing companies in a large geographic area.

In the present case it is the gas producers who are being regulated while at the time of the *Hope* case they were considered to be completely exempt from Federal Power regulation. In fact, the court remarked in passing that "the Federal Power Commission was given no authority over the production or gathering of natural gas" 320 U.S. 611, which indicates the extent of the evolution of this field of law since 1944.

Another distinguishing factor is that in the *Hope* case the impact on West Virginia was indirect and relatively insignificant, whereas in this case the impact on New Mexico and Texas is direct and greater in degree than on any other party in the case.

These Petitioners respectfully submit that any language in the *Hope* case which might be construed as preventing the Commission from considering the producing states as being "a part of the public interest" should be clarified or reversed, and that this Court should make it imminently clear that the Commission

not only can but must consider the impact of its orders and rates as related to the conservation of the nation's natural gas resources.

POINT IV

The Commission has not designed rates to assure an adequate supply of gas for the future

The phenominal growth of the oil and gas industry over the past fifty years has been largely attributable to the successful operation of this country's free enterprise system. It is a risky business and the profits to the successful operator must justify this risk. Any attempt to treat this industry as a utility and to limit its returns to the level normally allowed a utility is to invite disaster. If the profit motive is removed the industry will surely die, for there are myriad other investment opportunities that will approximate the return of a utility which are much safer and far more assured than is the exploration for oil and gas.

The producer States are gravely apprehensive that the rates established by the Commission in the instant case will have a stifling effect on future exploration for gas in the Permian Basin. The only incentive to the producers for future exploration and development is price. The Commission expresses great confidence that its "higher" new gas-well gas price will provide adequate incentive for future exploration and development in the Permian Basin, but upon analysis this contention breaks down entirely. The only thing over which it is higher is the arbitrarily low flowing gas rate established by the Commission. The plain fact is that the only "incentive" the Commission has provided the producers in Opinion and Order Nos. 468 and 468-A is

a *price cut*. The record in this case reflects serious doubt as to whether even existing contract prices would elicit the level of future exploration and development necessary for new discoveries to keep pace with the pyramiding demand, and any reduction below this level is certain to further widen the growing gap between supply and demand.

It is therefore submitted that all parties concerned will ultimately suffer as a result of the Commission's action in this case. First, the producers will be deprived of a fair return on present investments and be forced to divert future investments elsewhere. Second, the producing states will be deprived of huge sums of direct revenue as well as suffer the depression and economic dislocation of many of its communities. And last, the consumer, while he may enjoy lower gas rates in the immediate future, will ultimately awaken to the stark reality that his demand for natural gas cannot be met at any price.

In order for a rate prescribed by the Commission in this or any case to be lawful it must successfully pass two tests. First, a rate must be "just and reasonable" to both producer and consumer. Secondly, it must be sufficiently high to elicit a level of future exploration and development that will assure a continuing supply of natural gas for the consuming public.

Both of these functions have been determined by Congress to be affected with the public interest and the Commission is charged equally with the performance of each. The matters to be considered by the Commission in the performance of the first function are, however, quite different and apart from those of the second.

This argument deals only with the question of whether the rates prescribed by the Commission in this case will pass the second test referred to above.

These petitioners chose to give separate treatment to this subject because their interest in the level of future exploration and development is somewhat different from that of the producers. The States of New Mexico and Texas have a governmental duty to conserve its natural gas resources to the end that they might be developed, produced and consumed in the most efficient manner possible.

Controlling the level of exploration and development is one of the functions of the conservation process and thus arises the particular interest of these States in this aspect of the Commission's deliberations in the instant case.

New Mexico and Texas throughout these proceedings have taken the position that the Commission failed to adequately consider the gas supply aspect of this case. The Commission urges that this is a question of fact on which petitioners have asked the Court to substitute its judgment for that of the Commission. This is not the case.

The thrust of our argument is that the Commission cannot possibly have assured an adequate supply of gas for the future by means of the procedures that it followed. There are three basic logical steps that the Commission must necessarily take in order to assure an adequate supply of natural gas for the future.

First, the Commission must determine the quantity of gas needed to constitute an adequate future supply. Secondly, it must make a conclusion as to the level

of exploration and development which will produce the needed gas supply. Finally, it must prescribe a rate which will elicit that level of exploration and development.

Nowhere in the Commission's opinion is there a finding or determination of the quantity of gas necessary to meet future demand. Surely some quantitative analysis of the expected demand must be made by the Commission before it can conclude that the future supply will be adequate to satisfy it.

Although the Commission concluded that the level of exploration and development for the period from 1960 through 1964 "represented an appropriate level for the future" it did not go on to make a finding that the rates prescribed by it would in fact elicit that or any other level of exploration and development.

The Commission argues that it adjusted the exploration and development allowance to encourage a satisfactory level of exploration. This is no answer at all. The argument *assumes* that the adjustment is sufficient encouragement to actually elicit the required level of exploration and development. This is the ultimate fact which the Commission was required to find in order to support its decision. It cannot be assumed.

Thus, it becomes apparent that the Commission has failed to complete its fact finding duties in connection with this issue.

As Mr. Justice Jackson observed in his *Hope* opinion,

> "Price is a 'tool' and should be employed 'to induce private enterprise completely and efficiently to utilize gas resources, to acquire for public

service any available gas or gas rights and to deliver gas at a rate and for uses which will be in the future as well as in the present public interest.'"

The ceiling prices established by the Commission's Order now under attack do not accomplish the purpose envisioned by Justice Jackson and are not in the public interest.

If prices for gas are not sufficient in the interstate market, then future gas discoveries will be withheld from that market and be consumed by the intrastate market. Even now more than *50* percent of Texas produced gas is being used by Texas industries and markets and that figure will continue to go higher each year. As stated by the *Dallas Morning News* on September 15, 1967 in covering a speech given by Railroad Commission Chairman Jim C. Langdon in Beaumont:

"INTRASTATE MARKET SEEN AS BOOM FOR TEXAS GAS

"Beaumont, Texas — Railroad Commission Chairman Jim C. Langdon predicted here Thursday that growing demand for gas within Texas will reach 'a level and a price' sufficient to create needed incentive to keep up with intrastate requirements.

"And, the chairman told a Beaumont Chamber of Commerce meeting, when this happens out-of-state gas consumers 'will probably have to return to higher-priced, unregulated, competing fuels until such time as the Federal Power Commission revises its rate making policies and makes it possible for interstate companies to contract for new gas.'

"Langdon charged that at present FPC rate making policy does not provide incentive for the gas industry to maintain reserves against growing overall demand.

"Langdon noted that from the standpoint of what is best for Texas in its own interest, far more benefits are realized from the sale and use of its own gas within the state than from that sold to interstate markets.

" 'A large and dependable supply of natural gas within the state has served to attract new industry to Texas,' the chairman stated. He pointed out several examples of such attracting, one being a huge complex United States Steel Corp. has under construction near Houston which will consume more than a million feet of gas per day when in operation, and elaborated:

" 'Texas obtained this plant largely because of the foresight of the owners of the major share of reserves in the huge Katy gas field (near Houston) whose decision not to commit this important reserve to interstate markets saved it for the current and future need of the people and industries of our own great state.'

"The chairman stated belief that with adequate incentive, the nation's gas finders could meet current and future needs of all consumers and concluded:

"The solution is simple and obvious—permit gas to find its fair, reasonable and just price in competition with other buyers and competing fuels in a free and open market. Then like other commodities, if the price became too high it would be reduced, or gas would be replaced . . . by a new, more economical, and perhaps even a better fuel than natural gas. This is the way it should be."

Also, as stated in the September 11, 1967 *Oil & Gas*

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Journal, pages 47-49 that Lone Star Gas Co. and United Gas Corporation plan to build lines into the Delaware-Val Verde area of the Permain Basin and offer deals which the interstate pipelines cannot match; however, the only problem is that there is not enough gas to go around. The article goes on to state that the impact of the entry of Lone Star and United on the gas market will be considerable. The article stated that:

> "The advantages of intrastate buyers include: higher average price, faster rate of take, no delay in getting approval, and lack of red tape since they are free of Federal Power Commission control.
>
> "For producers, delays in moving gas to market are costly. It's figured it costs 1 cent/Mcf for each year that a field is kept off the market. Under FPC policies, it takes about 6 months for a temporary certificate. A permanent certificate to sell gas to an interstate line may require a year or more.
>
> " 'The interstate lines can't compete with intrastate buyers,' says an executive vice-president of operations for Lone Star. 'We can beat their offers across the board. The prices are better, and we'll meet the other conditions right down the line.'
>
> "Last year when the deal to sell Katy field to Gulf Pacific fell through, Lone Star and United gobbled up most of the gas.
>
> "Many interstate lines had their eyes on this supply. But they weren't among the winners."

These petitioners say that the Federal Power Commission has failed in orders 468 and 468A to meet its statutory responsibility to assure an adequate supply

of natural gas to the detriment of not only the consuming public, but to the producing states as well.

CONCLUSION

Wherefore the States of New Mexico and Texas pray that this court reverse the Federal Power Commission and the Tenth Circuit Court of Appeals on each of the four points hereinabove raised.

Respectfully submitted,

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CERTIFICATE

I, LINWARD SHIVERS, Assistant Attorney General of Texas, a member in good standing of the Bar of the Supreme Court of the United States, hereby certify that on the 6th day of October, 1967, I served copies of the foregoing brief either in person or by mail, postage prepaid, to the office of the Solicitor General

of the United States, and to the General Counsel of the Federal Power Commission, respectively, Washington, D.C., and to the other attorneys of record in the Permian Basin Area Rate Cases.

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PETITIONER'S BRIEF

RESPONDENT'S BRIEF

SUPREME COURT, U. S.

OCT 9 19
JOHN F. DAVIS, C

IN THE

Supreme Court of the United States

OCTOBER TERM, 1967

Nos. 90, 100, 102, 117, 181

THE PERMIAN BASIN AREA RATE CASES

CONTINENTAL OIL COMPANY AND MIDHURST OIL CORPORATION,
Petitioners,

v.

FEDERAL POWER COMMISSION,
Respondent.

THE STATE OF CALIFORNIA,
Petitioner,

v.

SKELLY OIL COMPANY, ET AL.,
Respondents.

PACIFIC GAS & ELECTRIC COMPANY, ET AL.,
Petitioners,

v.

SKELLY OIL COMPANY, ET AL.,
Respondents.

FEDERAL POWER COMMISSION,
Petitioner,

v.

SKELLY OIL COMPANY, ET AL.,
Respondents.

CITY OF LOS ANGELES,
Petitioner,

v.

SKELLY OIL COMPANY, ET AL.,
Respondents.

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR PETITIONERS-RESPONDENTS CONTINENTAL OIL COMPANY AND MIDHURST OIL CORPORATION

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ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR PETITIONERS-RESPONDENTS CONTINENTAL OIL COMPANY AND MIDHURST OIL CORPORATION

OPINIONS BELOW

The opinion of the court of appeals (R. Vol. XII, pp. 15-61), as well as its opinion on rehearing (R. Vol. XII, pp. 87-89), are reported at 375 F. 2d 6. The opinions and orders

of the Federal Power Commission (R. 516d-826d, 827d-838d, 37s, 1105d-1132d, and 1133d-1136d) are reported at 34 F.P.C. 159, 418, 424, 1068, and 1082. The opinion of the Commission's hearing examiner (R. 97d-364d) is reported at 34 F.P.C. 306.

JURISDICTION

The judgments of the court of appeals were entered on January 20, 1967 (R. Vol. XII, pp. 62-83). An order modifying the judgments was entered, after rehearing, on April 18, 1967. The petition for certiorari in No. 90 was filed on April 17, 1967. The petition in No. 100 was filed on April 19 and a supplementary petition on May 4. The petition in No. 102 was filed on April 19 and a supplementary petition on May 8. On April 18, 1967, Mr. Justice White extended the time of the Federal Power Commission to file a petition for certiorari to June 19, 1967, and its petition (No. 117) was filed on May 1. Mr. Justice White, on April 17, granted the City of Los Angeles an extension of time until June 19, 1967, to file its petition, which was filed on May 20 (No. 181). All of the petitions were granted on June 12, 1967 (R. Vol. XII, pp. 89-90). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1) and Section 19(b) of the Natural Gas Act, 15 U.S.C. 717r(b).

STATUTES INVOLVED

The pertinent provisions of the Natural Gas Act, 52 Stat. 821, as amended, 15 U.S.C. § 717-717w, are printed in the Appendix to the Federal Power Commission's Brief, at pp. 173-181 thereof. A brief quotation from the Administrative Procedure Act, 60 Stat. 237, 5 U.S.C. § 1001, appears at p. 43 hereof.

QUESTIONS PRESENTED

1. Whether the establishment of rates for natural gas by

the Commission on rate-base cost-of-service determinations utilizing purported composite average industry costs, is arbitrary and discriminatory, and therefore unlawful.

2. Whether the Commission unlawfully ignored or refused to consider and make findings upon the evidence and issues pertaining to the economic facts and characteristics of the gas producing industry in establishing rates for natural gas.

3. Whether it was arbitrary and discriminatory and therefore unlawful for the Commission to establish a dual system of pricing providing different prices for identical gas based merely on the time at which gas sales contracts were executed, and the kind of well from which the gas is produced.

4. Whether, assuming *arguendo*, that the Commission could properly employ a cost-based method for determining area rates for independent producers of natural gas, the cost determinations made by the Commission, and the resulting rates, are invalid and erroneous.

STATEMENT

The decision of the Court of Appeals entered on January 20, 1967 sets forth in detail the procedural history and relevant background of this case (R. Vol. XII, pp. 22-28).

SUMMARY OF ARGUMENT

I. The Federal Power Commission's determination in this case, fixing rates (field prices) permitted to be charged by independent producers in the Permian Basin area, was based on cost computations which are inherently arbitrary and discriminatory and therefore unlawful.

The traditional rate-base, cost-of-service regulatory method, while well suited to regulation of rates of interstate gas pipeline utilities, is wholly inappropriate when applied to independent producers. The latter are in no sense public utilities; their number is legion and they are in constant, intense competition among themselves; they enjoy no exclusive franchises or protected markets; their exploratory efforts are fraught with great risks; their investments bear no relationship either to the volume of gas they produce or to the amount of revenues they realize; they are not engaged in rendering a utility service, but simply in selling a commodity.

Of paramount importance is the fact that most natural gas comes out of the earth mixed with other valuable commodities not subject to Commission regulation: crude oil and condensate. It is impossible to allocate accurately the joint costs of finding and producing the regulated commodity, gas, on the one hand and the unregulated commodities, oil and condensate, on the other. Every such allocation formula is innately unfair, arbitrary and discriminatory.

After six years of chaotic, unsuccessful attempts to fix producer rates on a cost basis, the Commission in 1960 declared it to be "not a sensible, or even a workable method of fixing the rates of independent producers." *Phillips Petroleum Company.* 24 FPC 537, 542 (Opinion 338). After reviewing the sound reasons for this conclusion, the Commission announced that it would henceforth regulate producer prices in area rate proceedings, using "some more manageable plan than the rate base method" (*Id.* at 547), and would "work out regulatory principles based on numerous other standards and criteria" (*Id.* at 548). The Commission's decision in Opinion 338 was affirmed by the District of Columbia Court of Appeals (303 F. 2d 380) and by this Court (373 U.S. 294).

Yet, in this, the first area rate proceeding conducted by the Commission, it has reverted to the senseless, unworkable cost-of-service method as a means of fixing producer prices. The result is that the Commission has prescribed prices which are totally inadequate to maintain the gas supplies needed by consumers and which, at the same time, are unfair, arbitrary, discriminatory and in many instances confiscatory. Such prices are, therefore, patently unlawful.

II. The Commission erred in rejecting voluminous, uncontradicted evidence of economic factors which should have been heeded and adopted as substantial bases for producer rate determinations. This evidence clearly demonstrated, among other things, (a) that much higher prices than those which the Commission has prescribed are essential to bring forth gas supplies adequate to meet future demand, and (b) that the producing end of the natural gas industry is effectively competitive, so that price levels prevailing in the market place are reliable indicators of just and reasonable gas prices.

The Commission rejected or ignored all of this evidence and, as a consequence, failed to adopt and apply a sound regulatory method.

III. The Commission established a dual pricing system, fixing a higher price for "new" gas-well gas than for all other gas, including "old" gas-well gas and casinghead gas (i.e., gas recovered from oil production, whether "new" or "old"). The higher price for "new" gas-well gas was arbitrarily and discriminatorily applied solely to gas which was committed to interstate sale on or after January 1, 1961. Ignored was the fact that the commodity value of natural gas is the same, irrespective of the date on which it is committed to sale and irrespective of the kind of well (gas well or oil well) from which it is produced.

IV. Assuming, *arguendo,* that field prices for gas may properly be based on cost, the Commission's cost computations were so complicated, inaccurate, arbitrary and capricious that they virtually defy analysis or even comprehension. We expose the infirmities of several important features of the Commission's fantastic cost computations at pages 43 to 66 of this Brief.

The Court below found itself unable to "unravel this snarl of statistics" (R. Vol. XII, p. 41). A regulatory method which is to massive and complex to permit appellate review cannot be a valid method. Indeed, it is no method at all, but simply a ukase for price freezing. More importantly, it is not even susceptible to judicial "end result" testing required by the doctrine of *Federal Power Commission* v. *Hope Natural Gas Company,* 320 U.S. 591.

ARGUMENT

I.

Determination Of Natural Gas Producers' Prices On The Basis Of Unit Cost Computations Is Inherently Arbitrary And Dsicriminatory And Therefore Unlawful

This Court's 1954 decision in *First Phillips*[1] required the Federal Power Commission to perform an exceedingly difficult task: to regulate commodity prices charged by thousands of competing, risk-taking natural gas producers under a statute designed to control the service rates of quasi-monopolistic public utilities.

The interstate gas transmission industry, at which the Natural Gas Act[2] was aimed, is composed of a relatively

[1] *Phillips Petroleum Company* v. *Wisconsin,* 347 U.S. 672 (1954).
[2] 52 Stat. 821-833 (1938), as amended; 15 U.S.C. 717-717w.

small number of companies which possess essentially all of the characteristics of public utilities. Their principal investments are in extensive pipeline systems, together with the pumping equipment needed to drive gas through those lines for hundreds of miles. The main business of these companies is the furnishing of gas transportation service to communities generally far removed from the source of natural gas supply. With few exceptions, these companies are enfranchised monopolies, authorized to serve exclusively certain specified geographical areas; and within each such area the particular company is, as a rule, insulated against competition from other interstate gas transporters.

The traditional rate-base, cost-of-service regulatory method — initially developed in regulating railroads and electric, telephone and other utilities — is well suited to regulation of interstate gas pipelines (R. 996-997, 1306). Their actual investments and operating costs are readily identifiable. Comparatively simple and limited cost allocations are called for. Moreover, since they are to a large degree shielded against competition, these transmission companies can reasonably expect a fair return on their investments and recoupment of their operating costs in their respective protected markets.

The situation of independent natural gas producers is entirely different. They are in no sense public utilities. Their number is legion, aggregating several thousands in the Permian Basin area and many more thousands elsewhere in the country (R. 217, 1242, 537d). The producers are in constant, intense competition among themselves in the search for and production and sale of gas (R. 10, 13-15, 140-141, 995-997). Their exploratory ventures entail great risks; they have no assurance that their exploratory efforts and expenditures will yield a return of any kind; there is no predictable or dependable relationship between the input

of dollars and the ultimate output (if any) of gas (R. 11-13, 68, 151, 177-185, 236, 995, 1288-1289, 1305-1306, 5e-6e, 60d). The producers enjoy no protected markets, and are granted no exclusive franchises.

Natural gas producers are not engaged in rendering a service but rather in extracting and selling a unique commodity. In its raw state, that commodity was formed by Nature millions of years ago and tucked into little pockets deep in the earth. It can only be found by drilling expensive exploratory wells, eight out of nine of which prove to be "dry" and total losses (R. 10-13, 229-230, 995). Where gas is found and brought to the surface, it usually comes mixed with crude oil, condensate or other substances from which it must be separated (R. 169 252, 1284, 111d, 533d-534d). And once it is produced and sold, the gas is gone forever (R. 202, 995). In this respect gas is totally unlike a service that can be repeated over and over again, or a herd or crop that propagates itself, or a manufactured article that can be turned out *ad infinitum* by a machine; gas is a wasting asset that can only be replaced by drilling more expensive, risky holes in the ground to find new reserves.

There are several additional aspects of the producing end of the gas business which distinguish it from the transportation function, including the following:

> Because of the hazards involved, funds to carry on exploration must as a rule be generated internally out of income derived from product sales; equity capital is generally not obtainable, and debt capital is almost never available, for exploratory ventures (R. 33-34, 172-193, 205-208, 234).
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> There is a prolonged time-lag (from three to as much as fifteen years) between a producer's investment in a prospective gas producing property and the commence-

ment of revenue from that property (R. 18-19, 68-72, 155, 203, 233, 1289, 133d).

Under institutional arrangements acceptable to pipelines and regulatory authorities, it is necessary that producers commit each of their gas reserves to long-term sales — generally in the range of from 20 years to the productive life of the field, which may be 40 years or longer (R. 99-101, 94e-111e (Col. g), 120d, 133d, 599d). Contracts covering such sales are negotiated at arm's length between the producer-seller and the pipeline-buyer (R. 134-136, 983-984).

Natural gas producers have no public utility obligation to search for or develop new gas reserves (R. 151); and when such reserves are found, the producer has the option of selling his gas in the regulated (interstate) market or in the unregulated (intrastate) market (R. 143-144).

The supply of natural gas is responsive to, and dependent upon, price (R. 141-144). True public utility services, by contrast, must be furnished regardless of cost and price.

The market price of natural gas — its commodity value — varies widely, even within a separate area such as the Permian Basin, dependent upon the gas' location, volume, pressure, Btu content, separation costs, delivery conditions and several other factors (R. 133-134, 972-983).

Not only is the producing industry internally competitive in all its phases, but its product, nautral gas, must be so priced that it can compete with many other sources of energy, including coal and oil and water, atomic and electric power (R. 14-15, 141).

Determination of the actual cost of exploring for, finding and producing natural gas is impossible in most instances because the gas is produced jointly with other valuable commodities — chiefly crude oil and condensate. No formula has yet been devised, or is in prospect, which can accurately allocate costs between these joint products. Indeed, every such formula that has so far been tried (including the wierd, complex computations essayed in this case) has proved to be not only wrong but also unfair, arbitrary and discriminatory.

Inasmuch as the gas transmission business differs so completely from the gas producing business, regulatory methods suitable for the former are wholly inappropriate for the latter (See R. 151, 1306). The Federal Power Commission came inevitably to this conclusion in 1960 in the *Second Phillips* case.[3] Yet, less than five years later, in the case at bar, the Commission has once more endeavored to fit the round peg of producer regulation into the public utility cost-of-service regulatory square hole. Of course, a complete misfit resulted; and we are here seeking to have it rectified.

A. The Demonstrated Invalidity of Regulation of Producer Rates on the Basis of Cost-of-Service and Other Unit Cost Estimates

Following this Court's 1954 decision in *First Phillips, supra,* footnote 1, the Commission labored through six years of attempts to regulate producers on the traditional cost-of-service basis. At the end of those long years of frustrating and chaotic experience, the Commission finally (and soundly) rejected the traditional cost-of-service con-

[3] *Phillips Petroleum Company,* 24 FPC 537 (Opinion 338 — 1960) aff'd *sub nom. Wisconsin* v. *Federal Power Commission,* 303 F. 2d 380 (D.C. Cir. 1963); aff'd 373 U.S. 294 (1963).

cept as a means of regulating independent producers. The Commission announced this awakening in *Second Phillips* (Opinion No. 338) on September 28, 1960.

> "Experience of the Commission . . . has shown, beyond any doubt, *that the traditional original cost, prudent investment rate base method of regulating utilities is not a sensible, or even a workable method of fixing the rates of independent producers of natural gas.* The fact that, in this case, we can, by making numerous arbitrary allocations and estimates, arrive at a calculated unit cost of gas does not prove to anyone's satisfaction, including ours, that we have thus solved the problem of fixing prices for natural gas sold by independent producers." (24 FPC at 542.)[4]

The Commission proceeded to demonstrate the completely different character of the producing end of the natural gas business vis a vis the transportation function:[5]

> *"Producers of natural gas cannot, by any stretch of the imagination, be properly classified as traditional public utilities.* Justice Harlan, dissenting in the recent case of *Sunray Oil Co.* v. *F.P.C.*, 364 U.S. 137 at p. 160, characterized the difference as follows:
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> "* * * A pipeline performs a service akin to those traditionally performed by public utilities. The independent producer, on the other hand, is unique among the objects of public-utility regulation because it is not engaged in rendering a service to the public in the conventional sense of that concept, but rather simply in selling a commodity which it owns * * *.
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> "A natural gas pipeline, under our regulation, usually has a fair opportunity to earn a fair rate of return,

[4] Emphasis is supplied by us in all quotations in this Brief, unless otherwise noted.

[5] See also Statement of General Policy No. 61-1, 24 FPC 818 (1960), wherein the Commission observed that the "producer segment of the natural gas industry differs from the pipeline transmission portion in fundamental particulars."

but such is not necessarily the case with a producer. The pipeline investor is reasonably assured of the financial feasibility of a project before any funds are expended for construction. The pipeline constructs facilities only after the issuance of a certificate of public convenience and necessity and reasonable assurance of fair rates. The producer must invest his funds prior to ascertaining whether he will have anything to sell or whether, if he does, he will have an adequate market. *Thus it is clear that in regulating producers we are faced with problems entirely different from those presented by an ordinary public utility.* Furthermore, to fix rates of gas producers simply by allowing a return on investment or rate base will penalize the efficient or fortunate producer and will unduly reward the inefficient or unfortunate producer. As Justice Jackson put it in his dissent in *F.P.C.* v. *Hope Natural Gas Co.*, 320 U.S. 591 at 649:

> "* * * The service one renders to society in the gas business is measured by what he gets out of the ground, not what he puts into it, and there is little more relation between the investment and the result than in a game of poker."

> "Virtually the only situation in which the investment would have a real relationship to the return is where the producer has purchased fully developed acreage at a current fair price. Otherwise the determination of the cost of a producer's assets upon the happening of a certain event, or at a certain point in time will produce unrealistic and inequitable results." (24 FPC at 542-543)[6]

In its Opinion 338 the Commission also took pains to point out the inherent inaccurateness and unreliability of any attempt to allocate joint costs in producer cases:

> "We are not dealing with a service requiring certain equipment at known costs. We are dealing in many

[6] The Commission frankly points out these same distinctions in its brief before this Court. See, e.g. Comm. Br. pp. 49-55.

instances with one of two commodities produced with the same equipment and processed to varying degrees prior to sale. The price of the second commodity, oil, is unregulated, as is that part of the gas, which is sold in intrastate commerce or other transactions not subject to our jurisdiction, as well as the products which are extracted prior to shipment. Thus we are faced with the extremely difficult problem of allocating costs between the regulated and unregulated products. . . . [N]one of the experienced, diligent, and intelligent experts who have labored on this problem have proposed any allocations which were acceptable to other experts. Every method of allocation advanced was shown to have at least some element of guesswork or to ignore some facts.[7]

"While we must make allocations in all rate cases, the amounts involved in electric and gas pipeline cases have been comparatively small, and the allocations relatively simple. In the case of the producer, the amounts involved in the allocations of costs are major in size and extremely difficult to make. *The result is that a producer actually could become bankrupt, or could make enormous profits, depending merely on the methods of allocation used* . . .

". . . [*I*]*t is clear that the calculation of the unit cost of gas is, and will be an inexact, complex, unsatisfactory, and time consuming process, fraught with controversy.* The result finally reached may give the illusion of accuracy since mathematical processes are involved, and a definite price per Mcf is the final result. *But such a result must be tested against the realities of the market place.* Thus, prices calculated solely on the cost rate base principle cannot be accepted if they are higher than a buyer will pay, or lower than a seller will accept.

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[7] As a matter of fact, virtually every reputable accounting and economic authority recognizes that all cost allocation methods are inaccurate, arbitrary, and virtually meaningless. See footnote 9, post, pages 18 and 19.

> "When an unrealistic result is reached, the formulae for allocations must be changed, in order to bring about a reasonable result. *The allocation methods then become a means of supporting a result already arrived at, rather than a means of arriving at a result which was previously unknown.*" (24 FPC at 543-544.)

The Commission went on to note several other fundamental differences between producers and public utilities, including the uncertainty of estimates of gas reserves, the treatment of income tax allowances for depletion and intangible drilling costs peculiar to producers, and the substantial cost and revenue fluctuations from year to year which make any test-year cost-of-service standard inappropriate for producers (24 FPC at 544, 545). In the course of this discourse, the Commission declared at one point:

> "Ridiculous results will be reached among the great number of producers and owners of interest if costs should be the only basis for regulation." (24 FPC at 544)

In concluding this part of its Opinion 338, the Commission said:

> "From the foregoing, it follows that effective regulation of the price of natural gas must be on some more manageable plan than the rate base method." (24 FPC at 547)

The Commission thereupon declared that it would embark upon a new and different course of producer regulation — area rate proceedings in which field price would be determined for all natural gas within various separate and distinct producing areas. With respect to such proceedings, the Commission announced:

> "Our ultimate objectives will be to set prices in all producing areas which will be adequate to maintain the gas supplies needed by the consumers of the nation,

> but at prices that are no higher than are necessary to accomplish that purpose." (24 FPC at 547)

And in setting such area prices, it was promised, determinations would take into account "fair prices for gas, based on reasonable financial requirements of the industry and not on the particular rate base and expenses of each natural gas company" (24 FPC at 547). This, said the Commission, would be in consonance with practices followed by other agencies in "dealing with competitive industries"; i.e. "to work out regulatory principles based on numerous other standards and criteria [other, that is, than the conventional rate-base method]. Producer regulation will have to be based on similar considerations." (24 FPC at 548)

To support its proposal to conduct area rate proceedings, freed from rate-base, cost-of-service shackles, the Commission quoted at length from the prophetic opinions of Justice Jackson in early Natural Gas Act cases:[8]

> "In his concurring opinion in *Colorado Interstate Gas Co.* v. *F.P.C.*, 324 U.S. 581, Justice Jackson anticipated the chaos . . . when he stated at page 610:
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> "To let rate-base figures, compiled on any of the conventional theories of rate-making govern a rate for natural gas seems to me little better than to draw figures out of a hat. These cases confirm and strengthen me in the view I stated in the *Hope* case that the entire rate base method should be rejected in pricing natural gas, though it might be used to determine transportation costs. These cases vividly demonstrate the delirious results produced by the rate-based method." (24 F.P.C. at 545).

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[8] So cogent are these views of Justice Jackson that we have, for the convenience of the Court, reproduced pertinent portions of his dissenting opinion in the *Hope* case (324 U.S. 591, 628-660) and his concurring opinion in the *Colorado Interstate* case (324 U.S. 581, 608-615) in the Appendix to this Brief (*post*, pp. 1a-15a).

"As Justice Jackson stated in his concurring opinion in *Colorado Interstate, supra,* at p. 613:

"* * * Far sighted gas-rate regulation will concern itself with the present and the future, rather than with the past, as the rate-base formula does. It will take account of conditions and trends at the source of the supply being regulated. It will use price as a tool to bring goods to market — to obtain for the public service the needed amount of gas . . . [I]f the supply is not too plentiful and the price is not a sufficient incentive to exploit it and fails to bring forth the quantity needed, the price is unwisely low, even if it does square perfectly with somebody's idea of return on a 'rate base'. . .

"And as the same justice concluded in the *Hope* case, *supra* [320 U.S. 591] at page 650:

"* * * If natural gas rates are intelligently to be regulated we must fit our legal principles to the economy of the industry and not try to fit the industry to our books * * * " (24 FPC at 548).

The decision of the Commission in *Second Phillips* was affirmed by the District of Columbia Court of Appeals (303 F. 2d 380) and then by this Court (373 U.S. 294). On the aspect of the case which concerns us here, the Court of Appeals said:

"We think it is clear that the Commission had ample authority to embark upon an effort to design suitable standards for use in the regulation of producers when it found that the tools at hand were not suited to this purpose." (*Wisconsin* v. *Federal Power Commission,* 303 F. 2d at 387).

And this Court's opinion, written by Justice Harlan, dealt with the point in these words:

"We recognize the unusual difficulties inherent in regulating the price of a commodity such as natural gas. [Citing the opinions of Justice Jackson in the *Hope* and *Colorado Interstate* cases.] We respect the Com-

> mission's considered judgment, backed by sound and persuasive reasoning, that the *individual company cost-of-service method is not a feasible or suitable one for regulating the rates of independent producers.* We share the Commission's hopes that the area approach may prove to be the ultimate solution." (*Wisconsin* v. *Federal Power Commission,* 373 U.S. at 310).

This Permian Basin case, now before the Court, constitutes the first step in the Commission's brave new start on the road to regulating natural gas field prices on an area basis. *If* the Commission had stuck to its announced objective: to fix prices "which will be adequate to maintain the gas supplies needed by the consumers of the nation" (24 FPC at 547); and *if* the Commission had determined such prices, as promised: "based on reasonable financial requirements of the industry and not on the particular rate base and expenses of each natural gas company" (*Id.*); and *if* the Commission, in dealing with this competitive gas producer industry, had worked out regulatory principles "based on numerous . . . standards and criteria" other than cost (24 FPC at 548) — had these three vital "ifs" been fulfilled, then there would be little ground for seeking reversal in this Court.

Unfortunately, however, the Commission has, instead, jettisoned the entire substance and rationale of its affirmed *Second Phillips* decision. The Commission has tied its price determinations to supposed "costs" and nothing else; it has used exclusively purported nation-wide or area-wide "costs" which are representative of nothing that is real; it has refused even to consider the vast amount of impeccable economic evidence introduced by the gas producing industry; it has compounded the errors inherent in allocating "costs" of a single producer by allocating "costs" on a group basis with perfectly grotesque results; it has proposed two different price ceilings for the same product, natural gas, on the

basis of fantastic, arbitrary distinctions which do not exist. By these devices, the Commission has arrived at ceiling prices for gas in the Permian Basin area which are totally inadequate "to maintain the gas supplies needed by the consumers of the nation" and which, at the same time, are not only arbitrary, but also unfair, discriminatory, and in many instances confiscatory. These proposed ceiling prices are therefore patently unlawful.

B. The Fatal Defects of Gas Costing Are Not Overcome by Shifting from an Individual to a Group or Area Basis

The Commission's conclusion in *Second Phillips* (Opinion No. 338) — that cost-of-service is an inappropriate and unworkable regulatory method so far as the individual producer is concerned — is equally pertinent and valid with respect to regulation of producers generally as a group or in a given area.

The pervading defect and vice in cost-of-service regulation as applied to producers is that reliance must be placed on allocations of joint costs as beween the regulated commodity, natural gas, and the unregulated commodities, crude oil and condensate. By definition, all cost allocation methods of this kind are arbitrary and inexact. Accurate joint cost allocations are not simply difficult to make, but impossible, as reputable accounting and economic authorities all agree.[9]

If joint costs represented only a small part of producers' total costs involved, use of allocated "costs" might possibly be justified. However, 55% of the total costs used in the

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[9] For example: "Any allocation of costs must necessarily be arbitrary," Irston R. Barnes, *Economics of Public Utility Regulation*, p. 325 (F.-S. Crofts & Co., 1942).
"When products are produced jointly, that is, when one cannot be produced without the others, separate *true* costs cannot be found. In fact, there are no *separate costs* for the several pro-

Commission's determination of "new" gas-well gas prices and an even greater proportion of the total costs used in

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ducts. True joint costs for all may be compiled but these total costs cannot be accurately divided among the several products." Charles F. Schlatter, *Cost Accounting*, p. 652 (Wiley & Sons, 1948).

"When two goods are the inseparable result of one productive process, it is impossible to ascertain the separable costs of either as far as the process is concerned." Garver and Hansen, *Principles of Economics*, p. 181 (Ginn & Co. Rev. Ed. 1937).

". . . [J]oint costs cannot be traced to specific joint products and overhead costs are untraceable to specific units of service." Martin G. Glaeser, *Public Utilities in American Capitalism*, p. 424 (MacMillan Co., 1957).

"The vast majority of goods produced are joint products. The industry — in ascertaining the costs of its individual products — is faced with the impossibility of separating non-separable products. No accountant has been able to devise a method yielding by-product or joint-cost figures which does not embody a dominance of arbitrariness and guesswork." Walton H. Hamilton, *Cost as a Standard for Price*, 4 Law & Cont. Problems, 321, 328.

"There is no perfect, unassailable allocation of joint utility costs . . . Any allocation of joint costs is an arbitrary allocation." Emery Troxel, *Economics of Public Utilities*, p. 576 (Rinehart & Co., 1947).

"When the cost of raw material is joint, any method for allocating the joint cost to the various products tends to be arbitrary." *Product Costs for Pricing Purposes*, N.A.C.A. Bulletin, Research Series No. 24, p. 1696 (1953).

". . . [I]t is impossible to ascertain the costs of production of joint products." John Ise, *Economics*, p. 228 (Harper & Bros., 1946).

". . . [E]ven the most logical test allocation is more or less meaningless. Cost allocation is an institutional ritual." Eli W. Clemens, *Economics and Public Utilities*, p. 640 (Appleton-Century-Crofts, 1950).

"To some extent all methods of allocating joint costs to individual co-products rest upon opinion rather than upon objective measurements. In the words of one company representative, 'It is possible to determine *a cost*, but there is no way to determine *the cost* of a co-product.' Where the method for determining product costs is thus subjectively determined, equally competent accountants may arrive at quite different costs for the same product and there is no way to prove that one cost is more correct than another." (Footnote omitted). *Costing Joint Products*, National Association of Cost Accountants, Research Series No. 31, April 1, 1957, p. 28.

pricing "old" gas-well gas are allocated costs. (R. 180d, 870d). And, of course, computations involving oil-well gas use such allocated "costs" exclusively. The preponderance of joint costs thus arbitrarily allocated results in such uncertainty and so many inaccuracies that the unit cost computations made by the Commission in its Opinion 468 here under review are bound to be invalid. Any rate determination so infected with arbitrary cost allocations is, on its face, unlawful and an abuse of administrative discretion. The Commission recognized this truth in its Opinion 338 in *Second Phillips*.

In reviewing Opinion 468, the court below recognized the inherent vagaries of the Commission's costing approach. The Court noted that "the parties, the Staff and the Commission make many computations and reach many results." Describing the costing method as a parcel of "assumptions, allocations, formulae, equations, averages, means and massive calculations," the Court declined to be "drawn into such a turmoil of numbers." (R. Vol. XII, p. 41.) A regulatory method which is to massive and complicated to permit appellate review can hardly be deemed a valid method.

Indeed, the court below could not have uttered a more damning castigation of the Commission's costing methods had the court properly reviewed that method and found it to be fraught with every evil which we attribute to it. In failing to exercise its review function, the court stated that it could not "unravel the snarl of statistics" (R. Vol. XII, p. 41). Like Pontius Pilate at another trial, the court thereupon simply washed its hands of the whole thing, leaving the gas producing industry to its crucifixion on the Commission's cross of "costs".

If an able and learned appellate court finds itself incapable of coping with the snarled statistics, the turmoil of

numbers, and the massive calculations underlying the Commission's costing method, then the rates proclaimed by the Commission are not subject to any judicial review or end-result testing. Moreover, the "method" then becomes no method at all, but rather an imperious ukase for price freezing.

The Commission now contends that the fundamental faults that it recognized in the costing approach in *Second Phillips* (Opinion 338) pertain only to individual company cost-of-service regulation and not to area regulation on a group or industry basis. However, the vices of cost-of-service regulation are equally pernicious whether applied to an individual company or to a group (R. 105, 1284-1285, 1290-1304).

In fact, where a group is involved the critical problems are greatly aggravated. In attempting to determine an individual company's cost of gas, only that company's actual data need be used, and essentially all of the relevant data for that company are available and their accuracy can be verified. However, in the Permian Basin case the Commission has utilized purported "industry" data which in fact do not reflect the industry's operations. Moreover, such data were obtained from numerous diverse sources and are neither consistent nor comparable.

For purposes of its "old" gas (historical test-year) cost computations in Opinion 468, the Commission utilized data collected by its Staff through questionnaires. These questionnaires were directed only to those producers who were respondents to the Permian Basin Area proceeding, and not to all producers in the industry. One type of questionnaire was answered by large producers and another type by small producers. The latter were generally called upon to submit much less complete information as to their costs and operations. Questionnaires were mailed to 458

producers and 173 responses were received. However, the Commission used the data for only 44 large producers in estimating the cost of "old" gas, dropping out and thus ignoring the data for the smaller, higher-cost producers. Hence, the figures developed from the questionnaires reflected only the purported experience of the bigger, more successful producers. Yet, as the record shows, (R. 226; 1298-99; 4 Supp.), it is the thousands of small producers in the Permian Basin, rather than the handful of large integrated companies, who contribute the greater total effort to exploration, particularly in the higher-cost and higher-risk drilling of wildcat wells. It is this wildcatting, undertaken to such a significant degree by the small producers, which contributes most importantly to the overall effort of the industry to find new gas supplies.

In estimating the cost of "new" gas, the Commission used various published sources of "cost" information such as: "The Census of Mineral Industries for 1958, The Chase Manhattan Bank's 1961 Annual Analysis of the Petroleum Industry, The World Oil Magazine, The Oil and Gas Journal, The Joint Association Survey, and others," (R. Vol. XII, p. 40). This "snarl of statistics" comprises data collected for varying time periods and on differing, but always very limited, samplings of producing companies. These data are not reconcilable and cannot be used in composition to reach a representative cost determination for any producer or any group of producers. In this respect, the Commission's group approach has aggravated the fundamental defects of the entire costing process, in that the ultimate determinations are based on much less reliable data than would be used in an individual company rate case.[10]

[10] A more extended analysis of this subject appears later in this Brief, *post*, pp 44-45.

In short, unit costing of natural gas is even more arbitrary and invalid when done on a group basis than on an individual company basis. The unit cost of gas cannot be determined with any reasonable accuracy for either "new" gas or "flowing" gas. The actual unit cost of "new" gas cannot be determined, or even reasonably approximated, because of the inaccuracy, inconsistency, insufficiency and incomparability of the costing data employed. The cost of "old" gas cannot be determined because of the impossibility of accurately relating finding and development costs to the quantity of new supplies added by incurrence of such costs. Most critically, the in-fact cost of all gas is indeterminable because of necessary dependence upon fictitious joint cost allocations between gas and liquids.

As we have shown, all allocated joint costs are arbitrary and unreliable. The "costs" reached as a result of such allocations are, as the Examiner noted, a mere fiction (R. 183d). Furthermore, the choice of rate-base and rate-of-return allowed upon that rate-base in Opinion 468 are defective for lack of rational support. The rate-base itself ignores huge outlays of capital which are required for exploratory drilling. The rate-of-return is nothing but a subjectively derived conglomerate. It not only is supposed to represent a return on an inadequate rate-base, but also to cover such "risks" as finding sub-quality gas, although the impact of quality deviations is not ascertainable from the record in this case. Any rate determined under such a cost-based method, subject to all of these infirmities, can perform the regulatory function of bringing forth an adequate supply of gas only by blind chance. See *Colorado Interstate Gas Company* v. *Federal Power Commission, supra,* Justice Jackson concurring, 324 U.S. at 610; *post,* p. 13a.

Thus, even under the Commission's group approach to

costing, the fatal ills of cost-of-service are still present. Data problems are seriously aggravated; more than half of all costs must still be arbitrarily allocated; there is still the lack of relationship between cost and result; unit costs are still tied to unprovable reserve estimates; and an arbitrarily selected rate-base and a subjectively selected rate-of-return are still applied.

II.

It Was Error To Reject The Producers' Economic Evidence As A Substantial Basis For Rate Determination

We do not now ask this Court to prescribe a regulatory method, but we do ask the Court to decree the necessary or fundamental elements which must be present in whatever method of producer regulation the Commission may ultimately adopt.

The Commission has a dual responsibility to the consumers whose interest it is charged with protecting. The first is to see that rates charged for gas are no more than just and reasonable rates. The second is to see that the consumer is assured of a continuing adequate supply of gas to meet this needs. The latter responsibility is, in fact, an inherent part of the former, because a just and reasonable rate for natural gas is commonly defined as the lowest rate which will elicit adequate supplies.

The essentials of a proper regulatory method for producers were clearly set forth in Justice Jackson's concurring opinion in *Colorado Interstate*.[11]

In Opinion 468, the Commission recognized that "the rate must be one that the evidence indicates will elicit a

[11] 324 U.S. at 612. See quotations *ante*, p. 16 and *post*, p 14a.

level of exploration activity adequate to provide the increased gas supplies required by consumers in the future" (R. 573d-574d). However, the Commission proceeded to brush aside the question of adequate supply after arriving at contrived cost-based rates, and did not test those rates to determine whether they would, in fact, perform the necessary function of eliciting adequate supply. The Commission made no findings on this vital issue.

With reference to regulatory standards, since the producer's cost of gas (which cannot be determined) has never been the basis for prices charged for gas, and since an allocated cost of gas bears no relationship to the value of gas, and since the producer's cost of gas is not the determining factor as to whether he will risk large sums to explore for gas, the Commission's responsibility to see that there is continuing adequacy of supply cannot be "end result" tested by reference to costs. This end-result test can be made only by reference to economic factors such as levels and trends in exploration, supply and demand, and their relationships to price.

The Commission seeks to support costs as the sole basis for its rate determinations (and thus also excuse its disregard of economic factors) by means of the incorrect premises and lame, unconvincing reasoning found at page 55 of its brief:

> "However, the record of this proceeding does indicate that a producer's costs tend to average out over the years (R. 771-773) and that, on an industry or area basis, a substantial degree of stability in costs exists from year to year. (e.g. R. 778, 1194-1198, 208d-209d, 400e-401e).
>
> "This evidence strongly supports the feasiblity and fairness of establishing uniform area rates based on average costs. Under that method the average producer

will recover his costs over the long run; his good years will balance his bad; his costs will tend to approximate the group's experience."

The incorrect premises are that there is such a thing as an "average producer"; that any one producer will drill enough exploratory wells to make it likely that his average costs will approximate average industry costs; and that the record indicates that any individual producer's costs will average out over the years. The Commission's record citations are support only for the propositions that dry hole ratios are fairly stable on an industry-wide basis and that one cost element — per-foot drilling cost — is fairly stable from year to year on a country-wide basis.

The individual producer, large or small, makes no cost allocations (R. 1639). His investment decisions are not based on a purported average industry cost-of service, average industry success ratios, or average industry risks (R.1641-42). What does concern him are the answers to these questions: What will it actually cost to drill a particular well? What are the prospects of finding gas in commercial quantities as the result of such drilling? What price can be obtained for the gas, if found? Will he, the producer, be permitted to continue to collect that price? This is individual entrepeneurial judgment. It is the aggregate of these judgments, especially among the numerous smaller producers who do most of the exploratory drilling, which determines whether or not the supply of gas will be adequate. Since no producer has a utility obligation to drill for gas, it should be obvious that, given the same well drilling costs and the same prospects, more wells will be drilled at higher, more attractive gas prices.

Another way the Commission seeks to justify cost as the sole basis for its rate determinations (and thus excuse its rejection of economic factors as rate determinants) is to

misrepresent the producers' proposed method of rate determination. More than once, the Commission blandly proclaims that it had the mutually exclusive choice of basing rates (a) on cost, as advocated by its Staff and certain Intervenors, or (b) on contract prices, as advocated by producers. *No producer-respondent advocated so narrow a basis for rate determination as an evaluation of contract prices standing alone.* The vast majority of producer-respondents, including ourselves and nearly all major integrated companies, proposed comprehensive evaluation of numerous economic factors affecting the industry, not excluding unallocated industry-wide costs. Thus the Commission was *not* confronted with one or the other of two choices, but a wide range of choices.

We submit that it was error to select cost as the sole rate determinant, and we submit that it was error to reject the economic evidence adduced by the producers. Even if it were appropriate to use unit cost computations as the principal basis for rate determination (which we vehemently deny), such use does not preclude adjustments which are clearly dictated by the evidence on economic factors.

That this economic evidence was arbitrarily shunned and ignored is clearly evident from a comparison of such evidence with the declarations of the Commission in its Opinion 468. The Commission deliberately disregarded the effect of non-cost economic factors in its determination of ceiling prices.

> "In summary, when all of these factors are considered there is no justification in this area for any adjustment of a cost-determined ceiling price." (R. 614d)

Thus, it is clear that the Commission determined Permian Basin rates solely upon the basis of unit cost computations. The question, then, is whether the rejection of non-cost

economic evidence was so arbitrary as to constitute reversible error. We submit that it was, and regret the necessity for having to review that evidence at some length.

A. The Evidence on Supply and Demand

The economic evidence falls into two broad categories: (1) supply-demand levels, trends and relationships, and (2) general producing industry indicators. In addition, the record includes several consistent expert opinions that prevailing prices higher than the ceilings prescribed by the Commission in this case were already failing to elicit sufficient supply to keep abreast of demand. (See, *e.g.*, R. 34, 120, 167, 207-208, 1311-1312.)

With a reminder that all present gas supply has flowed from past exploratory efforts and that all future new supply must flow from present and future exploratory efforts, the following table is submitted as an aid to concise summarization of the thousands of pages of the record devoted to the supply and demand issue.

Supply and Demand Factors and Relationships*

Year (a)	Successful Exploratory Gas Wells (b)	Beginning of Year Reserve (c)**	Reserves Added During Year (d)**	Net Production (Actual Demand) During Year (e)**	Demand Forecast (f)**	Reserve to Production Ratio (g)	Reserve Additions Required to Maintain 17.5/1 R/P Ratio (h)**
1960	868	261.2	13.9	13.0		20.1/1	
1961	813	262.3	17.2	13.4	13.5	19.8/1	
1962	771	266.3	19.5	13.6	14.1	19.8/1	
1963	664	272.3	18.1	14.5	14.7	19.0/1	
1964	556	276.1	20.2	15.4	15.3	18.3/1	
1965	515	281.2	21.3	16.2	15.9	17.6/1	
1966	578	286.5	20.2	17.5	16.5	16.5/1	27.0
1967					17.1		27.6
1968					17.7		28.2
1969					18.3		28.8
1970					18.9		29.4

* All data through 1961 and some for 1962 are in the record. All data through 1964 were either in the record or within the official notice of the Commission well before issuance of Opinion No. 468 on August 5, 1965. Data for 1965 and 1966 are based on the same sources as for previous years, and are likewise within the official notice of the Commission.

** Trillions of cubic feet.

Sources: Col. (b) R. 569e; Cols. (c), (d) and (e) American Gas Association annual reserve study; Col. (f) R. 151e; Col. (g) = divide year end reserve by year's production, and AGA annual reserve study (in the record by reference to the Commission's files); Col. (h) = year's production ÷ 17.5 x increase over prior year's production (once the R/P ratio has reached 17.5 to 1).

The foregoing table shows nationwide levels, trends and ratios for gas supply and demand for the years 1960 to 1966 and a demand forecast, together with reserve additions needed to maintain a reserves-to-production ratio of 17.5 to 1, for the years 1967 to 1970. This table demonstrates beyond contradiction that, standing alone, the economic factors of supply and demand — as they have existed, as they now exist, and as they are projected into the future — make it mandatory that rates be higher than those determined by the Commission in this case. Otherwise, the Commission will fail to perform its prime regulatory responsibility of assuring an adequate supply of gas for the consumer.

Prior to 1960 the Commission had been allowing prices in the range of 18 to 21+ cents per Mcf in the Permian Basin. In 1960 the Commission issued its Statement of General Policy No. 61-1 (24 FPC 818) inaugurating area rate regulation and establishing guideline ceiling prices for each of the various areas therein delinenated. The ceilings set for Permian Basin were 16.0 cents per Mcf for "new" gas and 11.0 cents for "old" gas. The ceilings fixed for other areas were similarly below the prevailing prices. In 1965, in Opinion 468, the Permian Basin ceiling for "new" gas-well gas was set at 16.5 cents per Mcf; but, after quality reductions the effective ceiling is less than 16 cents. When the even lower ceiling of 14.5 cents for "old" gas and casinghead gas is taken into account, the effective ceiling for all gas is further reduced. Thus, the Commission decreed a reduced rate in 1960 and a still further reduction in 1965.

Col. (b) of the Table shows that the number of successful gas exploratory wells has been trending downward — a clear indication that the Commission's low ceiling prices during this period acted as a severe depressant. The reserves added (Col. (c)) have been erratic, reflecting the

lack of relationship between inputs and outputs, but the average over the seven year period (including reserves added by development drilling in fields found in prior years) comes to only 18.6 trillion cubic feet per year. This should be compared with Col. (h), which shows that 27.0 trillion cubic feet in reserve additions were required in 1966 to maintain a reserve-to-production ratio of 17.5 to 1. That requirement jumps to 29.4 trillion cubic feet in 1970 on the basis of the forecast figures in Col. (f). Reserve additions at such a high level have never been achieved by the industry. The actual demand figures in Col. (e) for 1964-1966 show both greater actual demand and greater year-to-year increases than the forecast figures in Col. (f). If this trend continues, substantially greater reserve additions than are shown in Col. (h) will be required to maintain the 17.5 to 1 ratio.

The Examiner expressed concern over the constantly declining reserve-to-production ratio shown in Col. (g), but speculated that the ratio would not reach 17.5 to 1 until 1970 (R. 121d). On this erroneous assumption, he concluded that there was sufficient supply assurance for the present. Note that in 1964, the year of the Examiner's Decision, the ratio was 18.3 to 1; that in 1965, the year of the Commission's Opinion, the ratio dropped to 17.6 to 1, and that in 1966 the ratio fell further to 16.5 to 1, *a full year of supply below the figure the Examiner thought might be reached in 1970*. At the average rate of decline for the 1960-1966 period (approximately .5 per year) the ratio will be 14.5 to 1 in 1970. *That is below the lowest figure of 15.0 to 1 any party to the proceeding deemed it safe to allow the R/P ratio to sink* (R. 125d). It must be borne in mind that full deliverability amounts to only about ⅔ of the reserve-to-production ratio (R. 92-96). For example, a 15-year supply at the current rate of production could

meet normal demand for only 10 years and peak demand for even fewer years.

Demand has headed sharply in the other direction; it climbed steadily from 13.0 trillion cubic feet in 1960 to 17.5 trillion cubic feet in 1966, and is forecast to reach 18.9 trillion cubic feet by 1970. As shown by Cols. (e) and (f), actual demand in 1964-1966 has exceeded the demand forecast for those years. Also, the forecast of Stanford Research Institute (R. 151e), which is employed in our table, is substantially below the forecast of the American Gas Association (AGA), which is 20.7 trillion cubic feet for the year 1970. Thus, well before 1970, actual annual production will undoubtedly exceed the average reserves added during the past seven years. We will not even be replacing what we produce. Yet the Commission declared that the economic evidence did not require any adjustment to its rates computed on the basis of unit-cost estimations!

Even without the testimony of C. M. Allen at R. 66-73, the Commission should know that exploration and development activities cannot be readily turned on. In response to lower prices, drilling effort declines, geologists and geophysicists go into other lines of endeavor, schools of geology shrink, drilling contractors go out of business, and drilling manpower evaporates (R. 202-203). Therefore, any sudden granting of higher prices will not promptly add new supply. Technical and labor forces must be reassembled, new geophysical work must be undertaken, leases must be acquired, exploration and development drilling must be started, sales contracts must be negotiated, and regulatory authority to make sales must be obtained. This adds up to a lag of several years, at best (R. 18-19, 68-70).

The adequacy of supply and the amount of future demand were vital issues in this case and were fully tried.

Yet the Commission disregarded all the evidence and made no findings thereon. We submit that the only finding which is justified by the evidence is that the prices established by the Commission in this case are much too low to fulfill the Commission's regulatory responsibilty to see that consumers have an adequate supply of natural gas.

B. The Evidence on Competition

This record fully supports the Commission's earlier view, expressed in its Opinion 338, that the gas producing industry is a competitive one and that regulatory principles applied to it should reflect that state of affairs.

> "In dealing with *competitive industries* such agencies as the Interstate Commerce Commission have found it best to work out regulatory principles based on numerous other [non-rate-base] standards and criteria. *Producer regulation will have to be based on similar considerations.*" (24 F.P.C. at 548)

There is not one shred of evidence in the record that the producers' market is anything but effectively competitive. Significantly, Opinion 468 contains neither an analysis of the evidence on this subject nor any findings in support of bare conclusions as to the absence of effective competition (e.g. at R. 555d-558d). However, Commissioner O'Connor in his Concurring and Dissenting Opinion wrote as follows:

> "On the record before us, there is no evidence of monopolistic power possessed by producers in the Permian Basin. *The issue, though properly raised by the producers has gone unnoticed by the other parties.* Respondents have met the burden of proof on the competition issue. Staff and the California intervenors have not. The state of the record is such that Respondents have made every possible showing of competition, and, further, they have shown that this competition is

sufficient, under a majority of contracts, to provide a meaningful methodology for determination of just and reasonable rates." (R. 734d).

To reach its contrary conclusions, the majority of the Commission had to ignore the undisputed evidence. Only a small portion of that evidence can be summarized here.

> "There has always been competition on the selling side, although in the past in many instances the pipelines had an effective control of the market. Due to the building of pipelines and the gain in opportunity of the sellers to make choices, the market is now more effectively competitive than in the past." (R. 140)
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> • • •
>
> "Producers of natural gas, unlike public utilities, have no exclusive control over a defined market area and no legal obligation to provide productive capacity to meet consumer demands." (R. 151)

The markets in which gas producers sell are effectively competitive by all the generally accepted tests used to determine the existence of competition or monopoly (R. 140):

> "Effective or workable competition now exists in the gas producing industry. . . . Neither the ownership of the natural gas producing industry nor the ownership of supplies purchased by the pipeline companies is concentrated in the hands of a relatively few. The number of producers is relatively large." (R. 140)

Concentration of ownership of production or control of sales is far below the levels of concentration in typical industries generally referred to as competitive (R. 140).

The behavior of gas prices is consistent with competitive conditions, and no evidence exists of price leadership on the part of producers; in fact, there has been a considerable

lag in the adjustment of historically depressed pricing areas due to price leadership exercised by buyers (R. 140).

It is relatively easy for newcomers to enter the industry or for existing companies to leave. Buyers and sellers are well informed (R. 140; 315).

The Commission also concluded that ". . . a limited number of producers control a large percentage of the gas reserves . . .", stating that 15 producers make about ¾ of all sales in the Permian Basin area (R. 556d). The Presiding Examiner found that 75 producers sell 82 percent of the jurisdictional gas (R. 154d). These, of course, are among the facts which cause qualified economists to conclude that the producing industry is competitive. (E.g., R. 140-141; 995.) Far from showing a concentration of economic power, the statistics show the producing industry to be among the least concentrated in the United States.

Gas production is the least concentrated of all extractive industries except bituminous coal. The 1958 U.S. Census Bureau statistics show 962 product classes with a higher concentration than gas producing.

A regulatory method which rejects evidence on the level of prices arrived at in a free market where there is no monopoly is arbitrary and unlawful. The level and pattern of prices existing in a free market must at least serve as a point of departure in making rate determinations. Regulated rates cannot lawfully be imposed in complete disregard of the prices freely arrived at in arm's-length bargaining. The regulated rate must stem from and be related to the prices which a free market has developed. These are basic principles of economics where a meaningful degree of competition exists in the market. The only excuse for disregard of market prices is in a monopoly situation; but the Permian Basin has been much closer to a monopsony than to a monopoly.

C. The Evidence on Price

The Commission's responsibility to see that the supply of gas is adequate to meet demand necessitates consideration of a vital factor — price. In relating the role of competition to the determination of just and reasonable prices, it is essential that the Commission consider the evidence showing the economic function of price:

> "Supply and demand are responsive to changes in gas prices. On the demand side, when demand tends to outrun supply, the economic function of higher prices is to control demand. . . . (R. 141)
>
> "On the supply side, when demand tends to outrun supply, increased prices for gas tend to stimulate the search for and development of additional supplies. Higher prices brought about by the operation of market forces, or fixed or approved by regulatory authority, provide the incentive for producers to search for gas in relatively less promising or more costly areas and to develop reservoirs that are smaller, located less favorably or producible at higher costs per unit of prospective output. In the long term, additional supplies cannot be made available without incurring the marginal and higher costs. Whether or not gas supplies will be adequate for the future will depend primarily upon the adequacy of the price incentive." (R. 142)

In the application of a regulatory method which looks to the reasonable revenue requirements of the industry the Commission should consider, among other things, the existing and historical price structure and price trends (R. 145-146), which reflect the prices upon which the industry has so far based its exploratory efforts.

The necessary role which consideration of existing market price evidence must play in determination of just and reasonable rates is aptly set forth at R. 148-149:

"The application of [a proper regulatory] method is necessarily in two stages or requires two steps. The first is to determine whether or not the general level of independent producer prices in the market is just and reasonable or not unreasonably high. The second step, assuming the general level of producer prices is found to be not in excess of producers' revenue requirements, is to determine whether or not any individual prices are unduly discriminatory.

"The general level of producer prices in the market is reasonable or not unreasonably high when not in excess of industry revenue requirements as that concept has been defined.

"A determination as to whether or not the general level of producer prices is too high or rising too rapidly presents no particular difficulty.

* * * * *

"The general level of gas prices is not unreasonably high *when prospective new supplies* are not excessive or *are inadequate in relation to demand* and, at the same time, the price level is changing at about the same rate as the cost of finding and developing new supplies. When new supplies are declining relative to demand, so that there is uncertainty as to adequacy of supply, field prices should be increased at a somewhat more rapid rate than drilling and other new supply costs. Otherwise, the prospect of declining profits will tend to further reduce available supplies relative to demand."

The role of current market prices in the regulatory evaluation is further demonstrated:

"The field price evidence is required for two reasons. The first is that the current prices represent the existing values in the producers' market which are guiding managerial decisions to invest in exploration and development. Therefore, current market prices have meaning and are useful as direct evidence of just and

reasonable prices to the extent the current prices are established in competitive markets" (R. 149-150).

"The second reason for looking to the structure and behavior of field prices is of course that it is the general level and pattern of prices which is subject to inquiry as to reasonableness in an area hearing" (R. 150).

In summary, market price evidence is of vital importance to the Commission's regulatory function of assuring adequate supply:

"The supply problem is so complex that regulatory judgment unaided by reference to the verdict of the competitive market cannot reliably fix gas prices which will be sufficient, but no more than required, to assure needed future supplies." (R. 155-156)

D. The Evidence on Other Industry Economic Factors

The revenue requirements of the industry have been *defined* to be the lowest rates which will provide for producers the incentive to explore for and develop the supply of gas needed to meet the demands of consumers. Such revenue requirements cannot be *measured* by reference to cost computation, but must be measured by economic factors underlying the gas producing industry (R. 1283-84). In addition to factors respecting supply and demand and competitive prices, there are other economic factors which aid in the measurement of revenue requirements: the level, trend and productivity of drilling, earnings in the industry, the cost trend in the drilling of wells, and the concomitant level of drilling activtiy.

Suffice it to say that, as to these additional economic factors, the trends in both drilling activity and drilling productivity are *down*,[12] the trend in earnings on invest-

[12] R. 53; 66; 119; *cf.* R. 21, 25-26.

ment is *down*,[13] whie drilling costs are *up*.[14] These economic facts of life are not conducive to fixing rates below the prevailing levels.

Objective rate determination requires full consideration of the evidence on all of the foregoing economic factors affecting the producing industry and the gas consuming public. Findings thereon (which in general, the Commission failed to make) should be incorporated in the regulatory method adopted. That the record contained ample evidence on these factors, and that the evidence proved a need for higher rather than lower rates, is demonstrated by reference to R. 2-208, R. 1e-162e, 568e-569e, 916e-947e, and 963e-968e. A brief perusal of this portion of the record will convince this Court of the enormity of the Commission's error in failing to consider all of the relevant economic facts of the producing industry and therefore failing to adopt and apply a sound regulatory method.

III.

The Commission's Two-Price System Is Arbitrary And Discriminatory And Therefore Unlawful

In Opinion 468 the Commission established a dual pricing system. Ceiling prices were separately determined (1) for "new" gas-well gas and (2) for all other gas, including all "old" gas-well gas and all casinghead gas (whether new or old).[15] The higher "new" gas price is applicable only to sales of gas-well gas under contracts executed on or after

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[13] R. 685e-689e.

[14] R. 119; 163-64; *cf.* R. 20-23.

[15] The "new" gas ceiling is based on purported "current" average producer costs throughout the nation for new gas-well gas, and the "old" gas ceiling is based on purported historical average costs of producers in the Permian Basin area for gas-well gas in the test year. This same "old" gas cost was imputed to casinghead gas and residue gas.

January 1, 1961. The Commission asserted that this dual pricing system will provide an economic incentive for producers to direct their search for "new" gas because of the higher price it is permitted to command.

There are three fundamental faults with this dual pricing system. First, it creates an artificial price differential for a single commodity of identical value. Secondly, it erroneously assumes that the two-price *system* will provide incentive to explore for gas, whereas only the attractiveness of the actual price (as distinguished from a differential in price) can provide such incentive. And lastly, the two-price system creates the rankest sort of discrimination between (a) producers who committed their gas to jurisdictional sales at different points in time, and (b) between buyers who draw their supplies from areas dominated by "old" gas, versus those who draw their supplies from areas dominated by "new" gas.

There is no more fundamental economic principle than that two prices cannot exist for the same commodity in the same market at the same time. It is manifestly arbitrary and discriminatory, as well as economically unsound, to decree different prices for natural gas having the same commodity value merely because of the happenstance of the date of the contract under which such gas is sold, or the kind of well from which it is produced. Gas is gas, no matter when or where it is found. The consumer does not care how many years ago his gas supply was committed to a sales contract or out of what kind of a well it came.

The Commission admitted in Opinion 468 that "gas is purchased for its energy" (34 FPC at 221; R. 645d). The Court below similarly recognized that all gas of like quality has the same commodity value.

"All agree that gas is a commodity which is valuable

> as a source of energy. The householder does not care whether the gas which burns at the tip of his appliance comes from a gas well, an oil well, or as a residue product. To him gas is gas." (R. Vol. XII, p. 38-39)

Since the Commission's dual pricing system is based upon estimated *average* costs, which are then substantially lowered by quality reductions and contract limitations, producers are in fact presented with no real incentive to find and develop more reserves.

Working in the opposite direction from incentive is inflation. The Commission's historical cost formula makes no adjustment for changes in the size of the dollar. Since the historical cost is unadjusted for inflation in the two-price system, it denies producers any recovery of their costs in terms of current dollars. The gas producing industry is by its very nature a replacement industry. Hence, there can be no "windfall" profits (as the Commission suggests, should "old" gas receive the "new" gas price) when a product taken from inventory is sold at no more than the current cost of replacement. Indeed, an economic loss results if the product is sold for less.

Inherent in the Commission's two-price system, moreover, is the ultimate reduction of the very prices which provided the incentive to find and develop the now available supply. This defect is bound to have an adverse effect on future supply. In the next round of area rate proceedings, it seems, today's "new" gas will become tomorrow's "old" gas. Faced with this prospect of an early reduction in the present "new" gas ceiling price, producers will be loathe to incur the great expense and shoulder the tremendous risks of exploration.

The Commission's incentive argument for a higher ceiling for "new" gas fails to take into account the producing in-

dustry's dependence upon internal generation of the revenues necessary to provide funds for future exploration. Exploratory funds must be obtained from revenues available to producers at the time the exploration is undertaken. The record shows conclusively that today's prices for "old" gas must pay for tomorrow's exploratory activities and the future supplies of gas resulting from such exploration (R. 33-34, 55). Accordingly, it is the revenues received for "old" gas, rather than from "new" gas, which must provide the revenues needed to support exploratory programs to find additional reserves.

Besides the fundamental faults discussed above, the two-price system has an adverse consumer cost effect in at least three ways: (1) Producers' fears of price reductions call for a higher incentive price than would otherwise be necessary; (2) exploration and development of acreage already committed to the interstate market is discouraged; and (3) casinghead gas, all of which gets the "old" gas ceiling, will migrate to the intrastate market, forcing the interstate market to rely on the higher priced gas well gas. The last mentioned effect is of special significance in this case in view of the fact that there is already established an intrastate market capable of absorbing an unusually large portion of the Permian Basin output. Nationally, the intrastate market constitutes 40% of the total market (R. 144), while in the Permian Basin the intrastate market is 49% of the total (R. 36e).

Section 5(a) of the Natural Gas Act proscribes unduly discriminatory or preferential rates. This proscription must act with equal force whether the rate is established by a regulated party or by the Commission. In fact, the Commission has the express mandate of Congress to prevent undue discrimination.

Moreover, Section 10(e) of the Administrative Procedure Act, 5 U.S.C. § 1009, provides that the reviewing court ". . . shall . . . hold unlawful and set aside agency action, findings, and conclusions found to be (1) arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law . . .".

The action of the Commission in establishing two price ceilings for Permian Basin gas has, we submit, been demonstrated to be unduly dicriminatory, preferential, arbitrary and capricious. It must therefore be held to be unlawful.

IV.

Assuming, Arguendo, That Area Prices May Properly Be Based On Cost, The Commission's Cost Computations Were Arbitrary And Capricious And Therefore Invalid

Although the Court below declined to concern itself with the Commission's costing techniques, the Commission devotes a substantial part of its Brief (pp. 104-167) to a defense thereof. We are constrained to contest the Commission on this subject, lest the deficient and incorrect costing techniques it employed become "law" by default.

The costing of "new" and "old" gas raised more than three dozen issues, *on each and every one of which the Commission ruled against the producers.* We do not ask this Court to second-guess the Commission on each of these numerous issues. We shall, however, review a few of the Commission's more glaring mistakes to demonstrate how grievously wrong and arbitrary were the cost calculations employed in this case.

A. The Commission's Costing Methods for "New" Gas Are Unreliable and Unreasonable

1. The data underlying the Commission's costing techniques are of insufficient reliability to serve as an exclusive basis for pricing.

The sources underlying the Commission's cost of "new" gas-well gas ranged from respondent's books of account to compilations made by government agencies, trade journals, bank bulletins and trade association publications. This welter of data sources is not only characterized by a lack of uniformity in bases for reporting, but also includes samples of widely varying sizes and reflects many differences in techniques of data expansion. The resulting costs are thus no more than estimates subject to a wide degree of uncertainty.

The unreliable nature of these estimates is accentuated by the fact that a number of different sources entered into the computation of virtually each of the individual cost components making up the total cost result. To illustrate, the "successful well cost" component was computed by reference to four different sources: the U.S. Census Bureau was used for the cost per foot in 1958; the "Appendix Questionnaires" to trend the cost per foot from 1958 to 1960; the trade journal *World Oil* for the footage drilled in 1947-1961, and the American Gas Association for an estimate of reserves found (R. 272d-277d). The unreliability of the costing results was compounded by two further factors: First, different data sources were selected from several alternatives, so that each cost component became the subject of a range of uncertainty. Second, although the individual components of the cost of "new" gas are independent of each other, the Commission made them interdependent by computing ten out of the thirteen cost items (in varying degrees) in relation to "successful well

costs." Thus, the margin of error contained in that item, resulting from the use of diverse sources and time periods, pervaded the entire cost study, and became magnified through the artificial interdependency introduced by the Commission's computation techniques.

These factors are sufficient grounds for discarding the cost approach. But superimposed on the uncertainties resulting from the limitations of the data sources are the vagaries inherent in the allocations of the joint costs of oil and gas. The results are simply sophisticated exercises in arithmetic unrelated to the economic realities of the producing industry.

2. The Commission's determination of the rate base for "new" gas was unreasonable.

Aside from the unreliability of the data, and assuming *arguendo* that the Commission's estimate of individual cost components reflects its administrative expertise, its "new" gas cost estimate still cannot stand because of fundamental errors in the computation of the rate base, to which the Commission applied a 12% rate of return. The Commission proceeded on the assumption that gas wells are depleted over a 20-year period at uniform annual rates of 5 percent. Since the producer's capital outlays are to be recovered over a 20-year period, the Commission concluded that the initial capital outlay is 20 times the annual capital recovery charges (depreciation, depletion and amortization) on successful investments.

In computing a rate base by reference only to capital recovery charges on *successful* investments, the Commission deprived producers of any return on their approximately equal unsuccessful exploratory expenditures. The Commission computed the rate base at an amount equal to 11 years of annual capital recovery charges, representing

an investment base of 10 years (one-half of 20), plus an allowance of only one year for the Commission's conception of the time-lag between investment and first production. This method of computing the theoretical rate base was erroneous in two respects: it disregarded the time value of money, and it assumed a depletion period which falls short of the actual depletion period.

The Commission's rate base reflects the assumption that the net investment maintained by the industry — in the test year and every year thereafter throughout the assumed 20-year life of the properties — is 55% of the initial gross investment.[16] The fact is, however, that in the test year the actual investment is equal to 100% of the initial outlay. This disregard of the time value of money results in an understatement of the return on production investment by 1.42 cents per Mcf, or 27% of the 5.21 cents allowed by the Commission.

The Commission sought to defend its use of an average rate base on the ground that the net investments would decrease each year and thus would require "a different price each year . . ." (Comm. Brief, p. 113). Administrative convenience may necessitate the computation of a constant price, but such a computation need not and should not be incompatible with the recognition of the time value of money.

In the court below, the Commission recognized the need to reflect the time value of money, stating:

> "As to the gas reserves found each year, the related investment will represent a new and separate rate base which starts at 100 percent of gross investment and diminishes to 0. Thus, unless the Commission were

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[16] The rate base being computed at 11 years is equivalent to 55% of the assumed 20-year life.

> constantly to readjust the price for gas found in a given year, it was necessary to use a formula that would provide for a constant price *without depriving producers of the time value of their investment*" (Comm. Brief to C.A. 10, p. 128).

Clearly, the use of a simple average period of ten years, plus one year for time lag, did not reflect any consideration of the time value of money.[17]

The Commission's rate base computation also cannot stand due to the arbitrary assumption of a 20-year life. Even the Distributor Intervenors concede that non-associated gas reservoirs are depleted, at varying annual rates, over an average period of 37 years (R. 778e-779e). In endeavoring to simplify the calculations for a 37-year period, the Commission sought to find a depletion period which, at equal annual depletion rates, would yield a result equivalent to that obtained by a return on investment depleted at varying annual rates. In seeking such simplification, the Commission adopted a 20-year period with an assumed equal annual depletion rate of 5%. The adoption of such a simplified, theoretical equivalent may lie within the Commission's ambit, but the Commission's end result conflicts with the objective sought. The theoretical equal annual depletion equivalent to the actual 37-year production pattern is 22 years, not 20 years. The impact of a change from 20 to 22 years on the total cost of gas is 0.6 cents per Mcf.

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[17] The Commission chose to treat the new gas rate base as analogous to a liquidating business, "which starts at 100 percent of gross investment and diminishes to 0" (Comm. Brief to C.A. 10, *Ibid.*). The producing industry is, of course, not liquidating but expanding. Nevertheless, the average theoretical rate base computed by the Commission also would not accurately reflect the net investments maintained by an expanding industry. In an industry experiencing growth, net investments will never decline to 50 percent of gross investments, which is the level assumed by the Commission's theoretical average rate base, excluding the one-year time lag allowance.

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The Commission acknowledges that the actual period of production is longer than 20 years, but contends that elimination of the additional years of the production curve is more than offset by the greater-than-assumed 5% production rate in the early years (R. 594d-595d). That contention is repudiated by the evidence relied on by the Commission for this purpose, which demonstrates that the highest annual production rate for gas reservoirs is 4.61%, i.e., *below* the Commission's assumed 5% rate (R. 778e-779e). The Commission also seeks to substantiate its assumed 5% annual depletion rate by contending that it is consistent with what the Commission asserts is the "industry's own accounting practice" (Comm. Brief, p. 114), a reference to the average depletion rate on "old" gas properties. Comparison of an average *accounting* depletion of "old" gas properties (reflecting a conglomerate of different vintages and widely varying states of depletion) with future physical depletion rates on recently discovered reservoirs is, of course, wholly inappropriate and without evidentiary support. Moreover, the Commission concedes an "element of artificiality in the average investment assumption" (Comm. Brief, p. 115), but contends that the end result was verified by production patterns which took into account the time value of money. However, the alleged verification was not made by reference to the 12% rate of return adopted by the Commission, but was based on a 9½% rate of return (R. 778e-779e). At a 12% rate of return, the verification technique would have demonstrated a return *deficiency* in the Commission's use of a theoretical average rate base.

The Commission's "new" gas rate base also fails to meet the "end result" test. The Commission's theoretical rate base assumes that there are 11 Mcf of reserves for each Mcf produced. The fact is that actual investments are equivalent to 17 Mcf of reserves for each Mcf produced.

The unreasonableness of this mathematically contrived rate base is also demonstrated by its failure to meet the Commission's stated objective. The "new" gas price is intended as an incentive to producers, reflecting the relatively higher cost (in comparison with older properties) experienced in more recent discoveries. Paradoxically, however, the Commission allows a lesser return per unit of "new" gas production than it does per unit of "old" gas (R. 578d, 634d, 823d). It borders on the absurd to contend that the "new" gas rate will encourage exploration when the Commission allows smaller earnings per unit on an admittedly higher cost of "new" gas.

3. Other errors and inconsistencies in the cost of "new" gas.

The Commission's cost of "new" gas-well gas is vitiated by at least three further errors and inconsistencies:

(a) Income taxes

The Commission failed to include an income tax allowance. This is in direct conflict with the evidence of the Distributor-Intervenors' witness whose computations the Commission accepted for virtually all other cost items, and whose evidence demonstrated an income tax cost of 0.60 cents per Mcf at a 12% rate of return. The Commission rejects the tax cost on the grounds that it was a "purely mathematical calculation" which the witness qualified with the statement that "many major producing companies in the past have been found to pay no income taxes . . ." (Comm. Brief, p. 138). Since the cost of "new" gas is intended to reflect the future cost of discoveries, the income tax computation must, of necessity, be a "purely mathematical calculation;" and the fact that some major producers have not paid income taxes in the past is not germane to the question of whether the entire industry will in the future incur a tax cost for "new" gas

at a 12% rate of return. Moreover, income taxes are dependent on profits (return), and since the return was computed by reference to a theoretical, not an actual, rate base, the income tax liability must correspondingly be computed on a theoretical, not actual, basis.

The Commission also contends that, in computing the income tax cost at 0.60 cents per Mcf, the witness "gave no weight to the predicted growth of gas exploration and development" (Comm. Brief, pp. 138-139. This argument well illustrates the Commission's inconsistency. If the Commission is correct in contending that growth must not be taken into consideration in computing the theoretical rate base (see Comm. Brief, p. 116), then the Commission should be precluded from considering growth in the income tax computation, since the tax is incurred on the return earned on the rate base.

(b) The net liquid credit

A further inconsistency is reflected in the Commission's determination of the "net liquid credit," representing revenues received for liquid hydrocarbons contained in the gas stream. The liquid credit reflects the increasing trend of condensate production *since* 1960, which is inconsistent with the Commission's use of a 1960 cut-off date for lease acquisitions and its refusal to take into account the higher cost of post-1960 lease acquisitions (R. 588d, 804d-805d). Also, the Commission's liquid credit reflects an upward adjustment to take account of the higher liquid yields encountered at greater depths to which gas wells are drilled. This is inconsistent with the computation of successful well costs, where the Commission ignored the higher cost resulting from deeper drilling.

The Commission's liquid credit was computed from data supplied by respondents to a Commission cost question-

naire. These data covered only a part of the total industry and were heavily weighted by companies whose gas production is at considerably greater depths than the industry average. Their liquid revenues, as well as their drilling costs, are thus higher than the industry average. The acceptance of these data is inconsistent with the Commission's rejection of a 1960 national drilling cost survey figure in favor of a 1958 U.S. Census figure on the grounds that the former is biased "toward the large companies, their deeper than average drilling and consequent higher cost per foot" (R. 276d).[18] The Commission now contends that "national figures which include old gas are less indicative of the condensate yield of new gas because those production data include substantial production from old, dry gas fields, such as the Hugoton Field" (Comm. Brief, p. 118). That contention rests on a generalization for which there is no quantification in the record and which, if correct, would vitiate the reliance on other national data, e.g., dry hole costs, which would be correspondingly understated due to the drilling of shallow holes in the Hugoton Field.

(c) The "adjustment" for exploration

A further illustration of both inconsistency and arbitrariness is provided by the Commission's determination of the "adjustment for exploration in excess of production"— more specifically, by the treatment of data for the year 1962. The finding costs —both successful and unsuccessful— were first computed by the Commission on the basis of reserve additions, which implies that the costs are to be recouped over the life of the reservoirs discovered. But the Commission held that the unsuccessful finding costs — comprising dry

[18] The Commission's additional grounds for rejecting the survey because of non-randomness and self-selection of the sample (R. 591d-592d) are not relevant to the issue here, since the cost questionnaire relied on by the Commission suffers from an even lesser randomness and even greater self-selection.

hole and other exploratory costs—should be treated as losses which must be recouped in the year in which incurred. It therefore became necessary to translate the unit cost expenses in terms of Mcf of reserves added into a cost per Mcf produced. To this end, the Commission used an "adjustment" factor of 37%, computed by reference to the ratio of reserve additions to production.[19]

Although the Commission stated that this was "a matter for careful judgment rather than scientific formula" (R. 583d), the language of Opinion 468 makes it clear that the factor was computed by reference to the 1960-1964 ratio of reserve additions to production, with the year 1962 being regarded as atypical and adjusted downward to the level of 1961 (R. 583d). The entire "new" gas cost computation having been made by reference to data ending in 1960, it was inconsistent to rely on the 1960-1964 period for the adjustment factor and to refuse to take into account data prior to 1960. But assuming, for the sake of argument, that the Commission might exercise its administrative expertise in choosing the 1960-1964 period, it nevertheless exceeded the bounds of its discretion in arbitrarily adjusting the 1962 data down to the level of 1961. Administrative expertise is the exercise of judgment in the interpretation of facts; *it does not extend to an alteration of facts.* The industry experienced an in-fact ratio of gas well gas reserve additions to production of 180% in 1962 and of 155% in 1961 (R. 582d). In view of the wide variations of the ratio from one year to the next, there is no rational basis for regarding any one year as atypical.

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[19] The name which the Commission gave to the "adjustment" gives rise to the charge that the Commission included "items of expense in excess of the actual cost of the gas . . ." (Brief, California Distributors, p. 15). The fact is that the Commission did not allow producers any excess over cost. The "adjustment" is simply a means of permitting recoupment of costs expended (R. 582d).

The numerous inconsistencies and arbitrary adjustments reflected in the cost of "new" gas demonstrate that the Commission overstepped the limits of its administrative discretion when such shortcomings are superimposed on grievous errors in the computation of the rate base, and when the basic data underlying the computations are themselves unreliable, it becomes clear that the Commission's computations of the cost of "new" gas cannot serve as a valid basis for pricing.

B. The Commission's Erroneous Determination of the Cost of "Old" Gas

1. The erroneous adoption of "area cost".

The evidence established that cost determinations, if made, should be made on a national basis, and should not be restricted to the Permian Basin area.

The Examiner stated (R. 182d):

> "National costs are likely to be more accurate than area costs because of the geographical fragmentation of company-wide costs required of area costing.
>
> • • •
>
> "The principal economists for respondents, distributors and Staff, Dr. Foster, Professor Kahn and Professor Wein, all testified that costs should be determined on a national basis. No economist testified to the contrary." [Footnote omitted.]

The Commission chose to disregard this evidence, and computed the cost of "old" gas on a mixture of national and Permian Basin area figures. The exploration component reflects an allocated portion of the national exploration costs, while the so-called production costs (comprising operating expenses, capital recovery charges and return on productive investments) reflected Permian Basin area costs (R. 634d).

In determining the cost of "old" gas, the Commission had two choices. It could either make a determination of revenue requirements on a national basis and then determine what part of the national revenue requirement should be generated from the Permian Basin area (which is the approach the Examiner followed), or it could make a cost determination restricted to the Permian Basin area. Assuming, without conceding, that the Commission did not exceed the limits of its discretion in disregarding the evidence that costs should be determined on a national basis, it was error for the Commission to mix national and area costs without ascertaining whether the producers can possibly recover those costs.

Since the Commission's "area cost" included an allocated portion of national exploration costs, the Commission has, in effect, allocated the remaining exploration costs to all other areas. Yet the Commission did not ascertain whether the portion allocated to other areas, coupled with the production costs in those areas, can be recovered from revenues generated in those areas. There is a great variation of costs among areas and an absence of relation between cost and price in different areas. Where the "area costs" exceed market price, the industry obviously cannot recover these costs. Thus, when the Commission uses "area costs" as a price ceiling, it in effect adopts a regulatory criterion of cost or market price, whichever is lower.[20]

The Commission's failure to determine whether revenues based on the sum of the different area costs will equal

[20] The Commission's failure to determine whether the producing industry will have an opportunity to recover costs will not be remedied in other area proceedings. In only one such proceeding, South Louisiana, has the same test year been used for costing purposes as in Permian Basin. Hearings in two further proceedings — Hugoton-Anadarko and Texas Gulf Coast — have already been concluded with the use of a different test year.

revenue requirement is particularly serious in view of the fact that the Permian Basin area boundaries were originally delineated, 24 FPC 818 (1960), on the basis of prevailing pricing patterns — which were wholly unrelated to cost considerations — and the Commission's subsequent refusal to consider whether its area designations were appropriate (24 FPC 1121, at 1122).

2. The Commission used inconsistent and erroneous allocation methods for exploration and development costs.

Exploration and development costs constitute the bulk of the outlays made for the finding of oil and gas reservoirs. These costs include dry hole, geological, geophysical and land department expenses. With the exception of the so-called development dry holes, these are joint costs, *i.e.*, they cannot be directly identified with either gas or oil reservoirs, and must therefore be allocated.

The Commission made three grevious errors in its determination of exploration and development costs. (a) It resorted to allocation in lieu of direct assignment of development dry holes; (b) it selected a wholly irrational method of allocation for the remaining exploration costs; and (c) it used inconsistent methods for allocating the identical cost component in its cost of "old" gas and "new" gas.

(a) Development dry holes

The universally recognized principle of all costing techniques is that, when costs are identifiable with a product or costing center (*e.g.*, a gas or oil reservoir), such costs must be directly assigned. The direct assignment avoids the use of allocation procedures, all of which are inherently arbitrary. Development dry holes are such directly assign-

able costs. As the name implies, they are drilled in the process of developing particular known oil or gas reservoirs and are thus directly identifiable with the type of reservoir into which the drilling takes place (R. 990; 1193-1194).

The Commission refused to assign directly the development dry hole costs to either oil or gas reservoirs on three grounds. First, it asserted that the data showing the direct identification were not the result of "a random sample" (R. 636d). The data covered 73% of the total development dry hole costs of the Appendix B and C companies. The question of whether the data reflect a random sample is, of course, significant only if there is a reason to believe that the distribution of the unreported data differs from that of the sample. In view of the magnitude of the sample, no one has suggested that this is the case.[21] Moreover, this would not in any event, justify a failure to assign directly the 73% of the development dry hole costs which were identified with particular gas or oil reservoirs.

Second, the Commission rejected the data because "expressions of 'intention' also involve subjective considerations." The suggestion that the direct identification of development dry holes involves subjective judgment in the classification of wells is factually erroneous and without support in the record.

Third, the Commission alleges that the Examiner found the method unsound because it ignored the economic pur-

[21] The Commission also notes that, "Interestingly, this step [direct identification] was not suggested by any witness who prepared a new gas-well gas exploration and development allowance" (Comm. Brief, p. 123, N. 95). The record shows that such direct identification *was* suggested (R. 991), but that no industry-wide data were available which were compatible with the industry-wide nature of the "new" gas cost studies.

pose of the driller. A more careful reading of the Examiner's decision demonstrates that the Examiner's criticism was not directed to the issue of direct identification, but to the subsidiary issue of the proposed vapor volume method of allocating the costs assigned to gas reservoirs between the gas and the liquids contained therein.

The result of the Commission's refusal to recognize the directly identifiable nature of these costs was to allocate 18.7% to gas reservoirs, whereas in fact 33% were directly identifiable with these reservoirs (R. 837e).

(b) The modified Btu method

Assuming, again without conceding, that the Commission's failure to assign development dry holes lay within the bounds of its administrative discretion, the Commission's use of the so-called "modified Btu method" for the allocation of all exploration costs was erroneous, because the method is not rational in relation to the purpose for which it was used. The essence of that method is to allocate joint costs in proportion to the heat content (Btu's) of oil and gas production volumes. However, the oil volumes are "modified" (weighted) by a factor of 3.5. This factor is allegedly derived from a series of economic relationships between gas and oil, but in reality the factor purports to reflect the higher sales value of a Btu of oil as compared to a Btu of gas. As the Examiner stated:

> "The rationale for this method is that it reflects the relative fuel values of gas and oil and also the relative market values due to the more valuable form of the liquids. While the Staff method is termed a 'modified Btu method' it is so heavily weighted by the relative sales realization of the products, that the term 'modified sales realization' is a more apt characterization." (R. 314d-315d)

The fundamental requirement of any allocation method is that it be a measure or approximation of the costs incurred by the respective joint products. The Commission's method — which essentially splits costs in proportion to revenues — does not meet that test. Moreover, it is vitiated by circularity. The defects of the method were further pointed out by the Examiner (R. 315d-316d):

> "But there is no showing here nor is there any reason from the evidence presented to infer that the relative sales values of oil and gas reflect their respective share of the total joint E&D costs.
>
> "Furthermore, sales realization, or a modification heavily affected by it, as a cost allocation is circular: that is, the price for a substantial item is used to determine the cost of the item, which is used to determine the price. In the modified sales realization method proposed here, the economic factors applicable in a subsequent rate proceeding will have been substantially influenced with respect to the gas side by the economic factors chosen here."

The Commission contends that it has "avoided circularity by using prices that were completely independent from the costing of old gas-well gas" (Comm. Brief, p. 122). It is correct that the Commission removed itself from the narrow circle of making the price of "old" gas determine the cost of the old gas. However, there remains the broader circle of using any price to determine cost which is then to be used as a basis of pricing. Thus, the Commission's method remains comparable to the "realization" allocations long condemned in rate regulation. See *Chicago M. & St. P. Ry.* v. *Tompkins,* 176 U.S. 167 (1900); *Simpson* v. *Shepard,* 230 U.S. 352, 461 (1913); *Re Separation of Operating Expenses,* 30 ICC 676 (1914); *Re Otter Tail Power Co.,* 8 FPC 393, 405 (1949).

A further reason why the "modified Btu" method is not a rational method for the allocation of exploration costs is that exploration costs are incurred for the *discovery* of oil and gas reserves, while the modified Btu method allocates exploration costs in proportion to test year *production* volumes of oil and gas. It thus implicitly assumes that the exploratory effort is proportional to, or reflected in, test year production volumes. However, the assumption is contrary to fact. The proportion of gas in total hydrocarbon reserves found is far greater than the proportion of test year production accounted for by gas. The Commission's modified Btu method therefore allocates an insufficient proportion of total cost to gas.

The Commission's third error in the determination of exploration costs lies in the use of inconsistent allocation methods for the cost of "new" and "old" gas. For "new" gas costs, the Commission allocated the unsuccessful exploration costs between gas and oil reservoirs either in proportion to the footage, or the cost, of the successful drilling effort for the respective reservoirs; then (ostensibly to take account of the liquids contained in the gas reservoirs) the Commission credited the revenues from liquids to the costs allocated to gas reservoirs, thereby attributing the maximum "cost" to liquids. If the identical methods had been used for "old" gas, the result would be a unit cost of 18.30 cents, compared to the Commission's 14.39 cents.

The Commission does not deny that the use of consistent allocation methods would have resulted in a significantly higher cost for "old" gas, but instead argues that the two costing concepts are not comparable. First, the Commission argues that the "new" gas reflects "methods for estimating future costs, not merely methods for allocating test year expenditures" (Comm. Brief, p. 125). This contention

is erroneous. Each of the components of the "new" gas costs is based either precisely on the 1960 test year[22] or on a four-year period ending in 1960.[23] The Commission also attempts to draw a distinction on the grounds that the "new" gas costs were evaluated "in the light of trends" (Comm. Brief, p. 125), whereas the "old" gas cost data reflected a single year's experience. This is a distinction without a difference. The purpose of trending in the cost of "new"gas (*e.g.*, successful well costs from 1958 to 1960) was, of course, to produce the equivalent of a 1960 cost.

The Commission further seeks to distinguish the "new" and "old" gas costs by the fact that the former are related to reserves added, whereas the latter are related to volumes produced, and contends that "The old-gas study cannot duplicate the new-gas methods because the trends in reserves found or added by the Permian respondents are unknown." (Comm. Brief, p. 125) Neither point is relevant to the issue. Allocation methods concern dollar costs.

Whether the allocated dollar costs are — for the purpose of expressing the result in the form of a unit cost — later divided by Mcf's found or Mcf's produced, is irrevelant to the propriety of the allocation method used. Moreover, in the costing of "new" gas, the dry hole and other unsuccessful exploratory costs — constituting 4.12 cents per Mcf compared to 3.95 cents per Mcf of successful costs — were not expressed on a per-Mcf-found basis, but were "translated into an allowance per Mcf of gas *produced*" (R. 582d).

The Commission further contends that the 18.30 cent result (referred to above) reflects an allocation of leasehold costs "wholly incompatible with the Commission's

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[22] Successful drilling costs, other production facilities, dry hole, production and regulatory expenses.

[23] Lease acquisitions and other exploratory costs.

treatment of lease-acquisition costs in its new-gas analysis" (Comm. Brief, p. 126). No such incompatibility exists. The 18.30-cent result reflects an allocation of past leasehold expenditures in proportion to the 1960 drilling costs for gas and oil reservoirs. The Commission alleges that "there is no reason to assume that the incurrence of these *past* expenditures for unsuccessful or untested leases can reasonably be related to *current* successful drilling costs". If there is indeed such incommensurability, it did not constitute an obstacle to the Commission. In the cost of "new" gas, the Commission allocated the cost of 1957-1960 leasehold acquisitions in proportion to the 1960 drilling costs (R. 803d-809d).

None of the Commission's arguments comes to grips with the propriety of its use of different methods for the allocation of identical cost components. The Commission's juggling of methods is capricious and illustrates how, in the Commission's own words, allocation techniques can become "a means of supporting a result already arrived at, rather than a means of arriving at a result which was previously unknown" (24 FPC at 543-544).[24]

3. The Commission's erroneous allocation of production costs.

Production costs consist of operating expenses, annual depreciation, depletion and amortization of investments in wells and equipment, and a return on these investments. In contrast to exploration costs, these production costs are

[24] The Commission also argues that its "trend-back method reconciles the new and old gas methods" (Comm. Brief, p. 127). In view of the inconsistent allocation methods employed, and the fact that the "new" gas cost is based on national data, and the "old" gas cost reflects a combination national-area cost study, the reconciliation is, of course, purely fortuitous. Moreover, the cost of "new" gas reflects such a serious understatement of the rate base that any trend-back is devoid of meaning.

directly identifiable with gas reservoirs consisting of dry gas and gas-condensate leases. The required allocation concerns the separation of the cost of gas from the liquids produced on gas-condensate leases.

The Commission made this allocation by the so-called "relative cost method", the theory of which is to allocate the joint products (gas and liquids) in proportion to the cost of producing each of the products under separate conditions.[25] The Commission therefore proceeded on the *assumption* — which conflicts with the facts and the evidence — that condensate is like oil. It therefore allocated the joint costs of gas and condensate in proportion to the costs of producing gas and oil separately.

The Commission's asserted reason for assuming that the cost of oil is substitutable for the cost of condensate is that "condensate liquids are a light oil largely interchangeable with crude oil" (Comm. Brief, p. 129), and that both have approximately the same market value. But these reasons are wholly unrelated to any factors bearing on the costs incurred in producing condensate and oil. For example, oil wells are typically spaced from one well per ten acres to one well per eighty acres, whereas condensate wells are typically spaced one well per 160 acres to one well per 640 acres. Where oil is produced as a separate product, it is generally lifted by pumps; however, that method is never used on condensate wells which are produced by reservoir energy.

The Examiner advanced cogent reasons for rejecting the relative cost method in the allocation of condensate leases.

> "The relative cost method of 'costing' joint products is not a costing method. There is no evidence that the

[25] The other product — gas — is produced separately in dry gas wells.

cost of producing oil from oil only leases and of producing gas from dry gas leases has any cost causal relation to the cost of producing lease condensate from gas condensate leases or of gas from oil wells. As Dr. Vietti, Respondent Texaco's witness shows, all these products are produced under different conditions, aside from the fact that they are discovered underground and brought to the surface through holes drilled in the ground.

"Moreover, the method can be and is applied with innumerable variations, each producing dfferent results. A relatively small variation in the cost or volume of the single product leases can, because of the leverage effect of the lags, produce substantial shifts in the allocation of the joint product costs. The reasons for preferring one variation to another are tenuous, although the differences in results can be substantial. There is no indication that the results of the relative cost method are closer to the separate product costs of joint production than relative values related to the cost of old and new gas-well gas. Nor is there any indication that they are more 'equitable'.

"There may be hyperbole in Texaco's description of the relative cost method as the 'villain of the piece'. But there is merit to its charge that the method invites statistical manipulation to produce desired results." (R. 325d-326d)

The Examiner's reasons stand unrefuted. The Commission's sole answer is that the method "is relatively simple and workable, has been accepted in principle in our electric power work for decades and has been repeatedly used and approved by the Commission in producer rate cases" (R. 632d). Simplicity and workability constitute, of course, an important element of administrative feasibility. But the requirements of administrative feasibility cannot be a substitute for a rational foundation, which the relative cost method lacks when it is used for condensate well costs.

The fact that the method has been employed in electric power cases is not relevant here, in view of the totally different factual circumstances. Nor is the argument that the Commission has used the method in other producer rate cases appropriate. In each of those cases, the allocation concerned not solely condensate leases, but also casinghead and combination (oil and gas) leases, for which the method may be better used. Thus, when the method was applied to all three types of leases, the results obscured the improper use for condensate leases alone. In this case, however, the Commission has limited the allocation to condensate leases. In these circumstances, a method which rests on an assumption which conflicts with the facts cannot stand.

The Examiner warned that "the method invites statistical manipulation to produce desired results" (R. 326d), but the Commission did not heed that warning. Thus, in allocating the net investment of gas-condensate leases, the Commission made an adjustment to the relative cost method and, instead of using a *net* investment basis, made the allocation on the basis of *gross* investments, thereby allocating an excessive amount of costs to oil. In support of this manipulation, the Commission contends: "The fact that the purpose of the allocation is to compute a return on investment is irrelevant, the test being which method more nearly reflects the operating facts of the joint production" (R. 821d). It is difficult to understand how the purpose of the allocation could conceivably be irrelevant to the issue of how it should be performed. Moreover, it is strange logic for the Commission to wish to reflect the "operating facts" — an allusion to the relatively older vintage (greater depletion) of oil only than dry gas leases — in applying the method, where rejection of the "operating facts" precludes a rational application of the method

to condensate leases. Also, whereas the Commission sought to support the use of the method by reference to other cases, the Commission is strangely silent on the point that in those other cases the method was applied on a *net* investment basis.

A second Commission adjustment involved the exclusion of shut-in leases (leases on which there are completed wells but no production) in computing the allocation ratio (R. 820d). The Commission justified this exclusion on the grounds that "Shut-in lease costs are not representative of the production costs of either gas wells or oil wells because they are essentially non-producers" (R. 820d). But the criterion of "representativeness" disregards the "operating facts" of the industry. The evidence established that shut-in leases are a normal and recurring phenomenon (and cost) of the production business. Moreover, the exclusion of shut-in leases does not accomplish the purported objective of establishing representative production costs. Virtually all (96%) of shut-in gas wells are located on completely shut-in gas leases; whereas, only 50% of shut-in oil wells are located on shut-in oil leases.[26] Thus, the Commission's shut-in adjustment results in an understatement of investments in gas (due to the exclusion of shut-in leases) which, in the application of the relative cost method, results in an understatement of costs allocated to gas.

In summary, it is clear that the Commission's allocation method for production costs rests on the erroneous assumption that the operating conditions of producing oil are similar to those of condensate. Moreover, even assuming *arguendo* that this is not a fatal defect, the Commission's application of the relative cost method cannot stand due to the use of capricious techniques. The significant impact

[26] On many oil leases production is obtained from more than one well (R. 1620-1621).

of these improper methods on the end result is, of course, illustrated by the fact that the use of allocation techniques for "old" gas consistent with those used for "new" gas would have produced a unit cost of 18.30 cents per Mcf for "old" gas.

The conclusion is inescapable that the Commission's allocations of both exploration and production costs are fraught with a series of substitutions, arbitrary assumptions instead of facts, and with methods that are irrational in relation to the purpose for which they are used. These defects are compounded by the use of capricious and inconsistent techniques of applying the different methods. The end results cannot form a lawful basis for pricing.

CONCLUSION

The judgments of the Court of Appeals insofar as they affirm the Commission should be reversed. The cases should be remanded with instructions that the characteristics of the gas producing industry preclude the use of unit-cost estimations as the primary basis of rate determination; that the two-price system is unduly discriminatory; and that the Commission, after reopening the record, (a) make record-supported findings respecting the economic factors affecting the producing industry and the consumers of natural gas, (b) adopt a regulatory method which takes such findings into account, and (c) set rates which reflect such findings to the end that both rate and supply regulatory functions are performed in such a manner that the interests of producers and consumers are reconciled.

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Excerpts from the dissenting opinion of Justice Jackson in Federal Power Commission v. Hope Natural Gas Company, 320 U.S. 591, 628-660 (1944).

[628]

By Mr. Justice JACKSON.

Certainly the theory of the court below that ties rate-making to the fair-value-reproduction-cost formula should be overruled as in conflict with Federal Power Commission v. Natural Gas Pipeline Co.[1] But the case should, I think, be the occasion for reconsideration of our rate-making doctrine as applied to natural gas and should be returned to the Commission for further consideration in the light thereof.

The Commission appears to have understood the effect of the two opinions in the Pipeline case to be at least authority and perhaps direction to fix natural gas rates by exclusive application of the "prudent investment" rate base theory. This has no warrant in the opinion of the Chief Justice for the Court, however, which released the Commission from subservience to "any single formula or combination of formulas" provided its order, "viewed in its entirety, produces no arbitrary result." 315 U.S. at page 586, 62 S.Ct. at page 743, 86 L.Ed. 1037. The minority opinion I understood to advocate the "prudent investment" theory as a sufficient guide in a natural gas case. The view was expressed in the court below that since this opinion was not expressly controverted it must have been approved.[2] I disclaim this imputed **[629]** approval with some

[1] 315 U.S. 575, 62 S.Ct. 736, 86 L.Ed. 1037.

[2] Judge Dobie, dissenting below, pointed out that the majority opinion in the Pipeline case "contains no express discussion of the Prudent Investment Theory" and that the concurring opinion contained a clear one, and said, "It is difficult for me to believe that the majority of the Supreme Court, believing otherwise, would leave such a statement unchallenged." [134 F.2d 287, 312.] The fact that two other Justices had as matter of record in our books long opposed the reproduction cost theory of rate bases and had commented favorably on the prudent investment theory may have influenced that conclusion. See opin-

particularity, because *I attach importance at the very beginning of federal regulation of the natural gas industry to approaching it as the performance of economic functions, not as the performance of legalistic rituals.*

I.

Solutions of these cases must consider eccentricities of the industry which gives rise to them and also to the Act of Congress by which they are governed.

The heart of this problem is the elusive, exhaustible, and irreplaceable nature of natural gas itself. Given sufficient money, we can produce any desired amount of railroad, bus, or steamship transportation, or communications facilities, or capacity for generation of electric energy, or for the manufacture of gas of a kind. In the service of such utilities one customer has little concern with the amount taken by another, one's waste will not deprive another, a volume of service can be created equal to demand, and today's demands will not exhaust or lessen capacity to serve tomorrow. But the wealth of Midas and the wit of man cannot produce or reproduce a natural gas field. We cannot even reproduce the gas, for our manufactured product has only about half the heating value per unit of nature's own.[3]

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[645]

The case before us demonstrates the lack of rational relationship between conventional rate-base formulas and natural gas production and the extremities to which regulating bodies are brought by the effort to rationalize them. The Commission and the Company each stands on a different theory, and neither ventures to carry its theory to logical conclusion as applied to gas fields.

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ion of Mr. Justice Frankfurter in Driscoll v. Edison Light & Power Co., 307 U.S. 104, 122, 59 S.Ct. 715, 724, 83 L.Ed. 1134, and my brief as Solicitor General in that case. It should be noted, however, that these statements were made, not in a natural gas case, but in an electric power case — a very important distinction, as I shall try to make plain.

[3] [Footnote omitted]

IV.

This order is under judicial review not because we interpose constitutional theories between a State and the business it seeks to regulate, but because Congress put upon the federal courts a duty toward administration of a new federal regulatory Act. If we are to hold that a given rate is reasonable just because the Commission has said it was reasonable, review becomes a costly, time-consuming pageant of no practical value to anyone. If one the other hand we are to bring judgment to our own to the task, we should for the guidance of the regulators and the regulated reveal something of the philosophy, be it legal or economic or social, which guides us. *We need not be slaves to a formula but unless we can point out a rational way of reaching our conclusions they can only be accepted as resting on intuition or predilection.* I must admit that I possess no instinct by which to know the "reasonable" from the "unreasonable" in prices and must seek some conscious design for decision.

The Court sustains this order as reasonable, but what makes it so or what could possibly make it otherwise, **[646]** I cannot learn. It holds that: "it is the result reached not the method employed which is controlling"; "the fact that the method employed to reach that result may contain infirmities is not then important" and it is not "important to this case to determine the various permissible ways in which any rate base on which the return is computed might be arrived at." The Court does lean somewhat on considerations of capitalization and dividend history and requirements for dividends on outstanding stock. But I can give no real weight to that for it is generally and I think deservedly in discredit as any guide in rate cases.[41]

Our books already contain so much talk of methods of rationalizing rates that we must appear ambiguous if we announce results without our working methods. *We are confronted with regulation of a unique type of enterprise which I think requires considered rejection of much conventional utility doctrine and adoption of concepts of "just*

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[41] See 2 Bonbright, Valuation of Property (1937) 1112.

and reasonable" rates and practices and of the "public interest" that will take account of the peculiarities of the business.

The Court rejects the suggestions of this opinion. It says that the Committees in reporting the bill which became the Act said it provided "for regulation along recognized and more or less standardized lines" and that there was "nothing novel in its provisions." *So saying it sustains a rate calculated on a novel variation of a rate base theory which itself had at the time of enactment of the legislation been recognized only in dissenting opinions.* Our difference seems to be between unconscious innovation,[42] and the purposeful and deliberate innovation I **[647]** would make to meet the necessities of regulating the industry before us.

Hope's business has two components of quite divergent character. One, while not a conventional common-carrier undertaking, is essentially a transportation enterprise consisting of conveying gas from where it is produced to point of delivery to the buyer. This is a relatively routine operation not differing substantially from many other utility operations. The service is produced by an investment in compression and transmission facilities. Its risks are those of investing in a tested means of conveying a discovered supply of gas to a known market. A rate base calculated on the prudent investment formula would seem a reasonably satisfactory measure for fixing a return from that branch of the business whose service is roughly proportionate to the capital invested. But it has other consequences which must not be overlooked. It gives marketability and hence "value" to gas owned by the company and gives the pipeline company a large power over the marketability and hence "value" of the production of others.

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[42] Bonbright says, " • • • the vice of traditional law lies, not in its adoption of excessively rigid concepts of value and rules of valuation, but rather in its tendency to permit shifts in meaning that are inept, or else that are ill-defined because the judges that make them will not openly admit that they are doing so." Id., 1170.

The other part of the business — to reduce to possession an adequate supply of natural gas — *is of opposite character,* being more erratic and irregular and unpredictable in relation to investment than any phase of any other utility business. A thousand feet of gas captured and severed from real estate for delivery to consumers is recognized under our law as property of much the same nature as a ton of coal, a barrel of oil, or a yard of sand. The value to be allowed for it is the real battleground between the investor and consumer. It is from this part of the business that the chief difference between the parties as to a proper rate base arises.

Is it necessary to a "reasonable" price for gas that it be anchored to a rate base of any kind? *Why did courts in the first place begin valuing "rate bases" in order to "value" something else? The method came into vogue* [648] *in fixing rates for transportation service which the public obtained from common carriers.* The public received none of the carriers' physical property but did make some use of it. The carriage was often a monopoly so there were no open market criteria as to reasonableness. The "value" or "cost" of what was put to use in the service by the carrier was not a remote or irrelevant consideration in making such rates. Moreover the difficulty of appraising an intangible service was thought to be simplified if it could be related to physical property which was visible and measurable and the items of which might have market value. The court hoped to reason from the known to the unknown. *But gas fields turn this method topsy turvy. Gas itself is tangible, possessible, and does have a market and a price in the field. The value of the rate base is more elusive than that of gas.* It consists of intangibles — leaseholds and freeholds — operated and unoperated — of little use in themselves except as rights to reach and capture gas. Their value lies almost wholly in predictions of discovery, and of price of gas when captured, and bears little relation to cost of tools and supplies and labor to develop it. Gas is what Hope sells and it can be directly priced more reasonably and easily and accurately than the components of a rate base can be valued. Hence the reason for resort to a roundabout way

of rate base price fixing does not exist in the case of gas in the field.

But if found, and by whatever method found, a rate base is little help in determining reasonableness of the price of gas. Appraisal of present value of these intangible rights to pursue fugitive gas depends on the value assigned to the gas when captured. The "present fair value" rate base, generally in ill repute,[43] is not even urged by the gas company for valuing its fields.

[649]

The prudent investment theory has relative merits in fixing rates for a utility which creates its service merely by its investment. The amount and quality of service rendered by the usual utility will, at least roughly, be measured by the amount of capital it puts into the enterprise. But it has no rational application where there is no such relationship between investment and capacity to serve. There is no such relationship between investment and amount of gas produced. * * * The service one renders to society in the gas business is measured by what he gets out of the ground, not by what he puts into it, and there is little more relation between the investment and the results than in a game of poker.

Two-thirds of the gas Hope handles it buys from about 340 independent producers. It is obvious that the principle of rate-making applied to Hope's own gas cannot be applied, and has not been applied, to the bulk of the gas Hope delivers. It is not probable that the investment of any two of these producers will bear the same ratio to their investments. The gas, however, all goes to the same use, has the same utilization value and the same ultimate price.

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[43] "The attempt to regulate rates by reference to a periodic or occasional reappraisal of the properties has now been tested long enough to confirm the worst fears of its critics. Unless its place is taken by some more promising scheme of rate control, the days of private ownership under government regulation may be numbered." 2 Bonbright, Valuation of Property (1937) 1190.

To regulate such an enterprise by undiscriminatingly transplanting any body of rate doctrine conceived and [650] *adapted to the ordinary utility business can serve the "public interest"* as the Natural Gas Act requires, *if at all, only by accident.* Mr. Justice Brandeis, the pioneer juristic advocate of the prudent investment theory for man-made utilities, never, so far as I am able to discover, proposed its application to a natural gas case. On the other hand, dissenting in Commonwealth of Pennsylvania v. West Virginia, he reviewed the problems of gas supply and said, "In no other field of public service regulation is the controlling body confronted with factors so baffling as in the natural gas industry, and in none is continuous supervision and control required in so high a degree." 262 U.S. 553, 621, 43 S.Ct. 658, 674, 67 L.Ed. 1117, 32 A.L.R. 300. If natural gas rates are intelligently to be regulated we must fit our legal principles to the economy of the industry and not try to fit the industry to our books.

As our decisions stand the Commission was justified in believing that it was required to proceed by the rate base method even as to gas in the field. *For this reason the Court may not merely wash its hands of the method and rationale of rate making.* The fact is that this Court, with no discussion of its fitness, simply transferred the rate base method to the natural gas industry. * * * The Court said this method was "based upon principles thoroughly established by repeated decisions of this court," citing many cases, not one of which involved natural gas or a comparable wasting natural resource. Then came issues as to state power to [651] regulate as affected by the commerce clause. * * * These questions settled, the Court again was called upon in natural gas cases to consider state rate-making claimed to be invalid under the Fourteenth Amendment. * * * No one seems to have questioned that the rate base method must be pursued and the controversy was as to what rate base must be used. Later the "value" of gas in the field was questioned in determining the amount a regulated company should be allowed to pay an affiliate therefor — a state determination also reviewed under the Fourteenth Amendement. * * * In both cases, one of which

sustained, and one of which struck down a fixed rate *the Court assumed the rate base method,* as the legal way of testing reasonableness of natural gas prices fixed by public authority, *without examining its real relevancy to the inquiry.*

Under the weight of such precedents *we cannot expect the Commission to initiate economically intelligent methods* of fixing gas prices. But the Court now faces a new plan of federal regulation based on the power to fix the price at which gas shall be allowed to move in interstate commerce. *I should now consider whether these rules devised under the Fourteenth Amendment are the exclusive tests of a just and reasonable rate under the federal statute,* inviting reargument directed to that point **[652]** if necessary. As I see it now *I would be prepared to hold that these rules do not apply to a natural gas case arising under the Natural Gas Act.*

Such a holding would leave the Commission to fix the price of gas in the field as one would fix maximum prices of oil or milk or coal, or any other commodity. Such a price is not calculated to produce a fair return on the synthetic value of a rate base of any individual producer, and would not undertake to assure a fair return to any producer. *The emphasis would shift from the producer to the product,* which would be regulated with an eye to average or typical producing conditions in the field.

* * * * *

Allowance in a rate to compensate for gas removed from gas lands, whether fixed as of point of production or as of point of delivery, probably best can be measured by a functional test applied to the whole industry. For good or ill we depend upon private enterprise to exploit these natural resources for public consumption. The function which an allowance for gas in the filed should perform **[653]** for society in such circumstances is to be enough and no more than enough to induce private enterprise completely and efficiently to utilize gas resources, to acquire for public service any available gas or gas rights and to deliver gas at a rate and for uses which will be in the future as well as in the present public interest.

The Court fears that "if we are now to tell the Commission to fix the rates so as to discourage particular uses, we would indeed be injecting into a rate case a 'novel' doctrine * * *." With due deference I suggest that there is nothing novel in the idea that any change in price of a service or commodity reacts to encourage or discourage its use. The question is not whether such consequences will or will not follow; the question is whether effects must be suffered blindly or may be intelligently selected, whether price control shall have targets at which it deliberately aims or shall be handled like a gun in the hands of one who does not know it is loaded.

We should recognize "price" for what it is — a tool, a means, an expedient. In public hands it has much the same economic effects as in private hands. Hope knew that a concession in industrial price would tend to build up its volume of sales. It used price as an expedient to that end. The Commission makes another cut in that same price but the Court thinks we should ignore the effect that it will have on exhaustion of supply. The fact is that in natural gas regulation price must be used to reconcile the private property right society has permitted to vest in an important natural resource with the claims of society upon it — price must draw a balance between wealth and welfare.

To carry this into techniques of inquiry is the task of the Commissioner rather than of the judge, and it *certainly is no task to be solved by mere bookkeeping but requires the best economic talent available.* There would doubtless be inquiry into the price gas is bringing in the **[654]** field, how far that price is established by arms' length bargaining and how far it may be influenced by agreements in restraint of trade or monopolistic influences. What must Hope really pay to get and to replace gas it delivers under this order? If it should get more or less than that for its own, how much and why? How far are such prices influenced by pipe line access to markets and if the consumers pay returns on the pipe lines how far should the increment they cause go to gas producers? East Ohio is itself a producer in Ohio.[44]

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[44] [Footnote omitted]

What do Ohio authorities require Ohio consumers to pay for gas in the field? Perhaps these are reasons why the Federal Government should put West Virginia gas at lower or at higher rates. If so what are they? Should East Ohio be required to exploit its half million acres of unoperated reserve in Ohio before West Virginia resources shall be supplied on a devalued basis of which that State complains and for which she threatens measures of self keep? What is gas worth in terms of other fuels it displaces?

A price cannot be fixed without considering its effect on the production of gas. Is it an incentive to continue to exploit vast unoperated reserves? Is it conducive to deep drilling tests the result of which we may know only after trial? Will it induce bringing gas from afar to supplement or even to substitute for Appalachian gas?[45] Can it be had from distant fields as cheap or cheaper? If so, that competitive potentiality is certainly a relevant consideration. Wise regulation must also consider, as a private buyer would, what alternatives the producer has [655] if the price is not acceptable. Hope has intrastate business and domestic and industrial customers. What can it do by way of diverting its supply to intrastate sales? What can it do by way of disposing of its operated or reserve acreage to industrial concerns or other buyers? What can West Virginia do by way of conservation laws, severance or other taxation, if the regulated rate offends? It must be borne in mind that while West Virginia was prohibited from giving her own inhabitants a priority that discriminated against interstate commerce, we have never yet held that a good faith conservation act, applicable to her own, as well as to others, is not valid. In considering alternatives, it must be noted that federal regulation is very incomplete, expressly excluding regulation of "production or gathering of natural gas," and that the only present way to get the gas seems to be to call it forth by price inducements. It is plain that there is a downward economic limit on a safe and wise price.

• • • • •

[45] [Footnote omitted]

[660]

Whether the Commission will assert its apparently broad statutory authorization over prices and discriminations is, of course, its own affair, not ours. It is entitled to its own notion of the "public interest" and its judgment of policy must prevail. However, *where there is ground for thinking that views of this Court may have constrained the Commission to accept the rate-base method of decision and a particular single formula as "all important" for a rate base, it is appropriate to make clear the reasons why I, at least, would not be so understood.* The Commission is free to face up realistically to the nature and peculiarity of the resources in its control, to foster their duration in fixing price, and to consider future interests in addition to those of investors and present consumers. If we return this case it may accept or decline the proffered freedom. *This problem presents the Commission an unprecedented opportunity if it will boldly make sound economic considerations, instead of legal and accounting theories, the foundation of federal policy. I would return the case to the Commission and thereby be clearly quit of what now may appear to be some responsibility for perpetrating a shortsighted pattern of natural gas regulation.*

Excerpts from concurring opinion of Justice Jackson in Colorado Interstate Gas Company v. Federal Power Commission, 324 U.S. 581, 608-615 (1945).

Mr. Justice JACKSON, concurring.

I concur in upholding orders of the Federal Power Commission in this and companion cases. The Court cannot, consistently with Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 64 S.Ct. 281, 88 L.Ed. 333, do otherwise.

The opinion in the Hope case laid down fundamental principles of decision in this language: "Under the statutory standard of 'just and reasonable' it is the result reached not the method employed which is controlling. **[609]** * * * It is not theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at an end. The fact that the method employed to reach that result may contain infirmities is not then important." Federal Power Commission v. Hope Natural Gas Co., supra, page 602 of 320 U. S., page 287 of 64 S.Ct. *This case introduced into judicial review of administrative action the philosophy that the end justifies the means. I had been taught to regard that as a questionable philosophy, so I dissented and still adhere to the dissent.* * * *

[610]

To let rate-base figures, compiled on any of the conventional theories of rate-making, *govern a rate for natural gas seems to me little better than to draw figures out of a hat.* These cases confirm and strengthen me in the view I stated in the Hope case that *the entire rate-base method should be rejected in pricing natural gas,* though it might be used to determine transportation costs. These cases vividly demonstrate the delirious results produced by the rate-base method. * * * **[611]** But I do think it is a fantastic method

of fixing a "just and reasonable" price for gas.[1] All of that, however, was thrashed out in the Hope case.

I do not recede from the views therein stated that Hope provides no workable basis of judicial review, no key by which commissions can anticipate what rule, if any, will control our review, and no guidance to counsel as to what issues they should try or how they should try them.

* * * * *

It is difficult for me in these cases, and in some it might be impossible, to follow the rule of Hope in reaching a decision. I have no intuitive knowledge as to whether a given price is reasonable, and my fundamental concept of reasonable price in this industry and how to find it has been rejected by the Court. But it happens that this case illustrates some aspects of the problem of pricing gas, as will appear from the reasons I shall state for the failure of the Company in this case to convince me that it is wronged by the reduction of prices ordered by the Commission.

[612]

Far-sighted gas-rate regulation will concern itself with the present and future, rather than with the past, as the rate-base formula does. It will take account of conditions and trends at the source of the supply being regulated. It will use price as a tool to bring goods to market — to obtain for the public service the needed amount of gas. Once a price is reached that will do that, there is no legal or economic reason to go higher; and any rate above one that will perform this function is unwarranted. If the supply

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[1] It does not help me to know what is a reasonable price for gas to learn what it does to outstanding securities. Many gas companies were organized and operated in care-free days when they issued stocks and bonds without supervision. It does not prove that a gas rate is too low to show that it does not pay dividends on inflated values. Nor is a rate proved excessive by the fact that it pays a large dividend upon an exceedingly conservative capitalization. I think Hope's use of return on stock or bond issues, repeated in these cases, is one of the least reliable of possible tests of rates.

comes from a region where there is such over-production that owners are ready to sell for less than a fair return on their investment, there is no reason why the public should pay more. On the other hand, if the supply is not too plentiful and the price is not a sufficient incentive to exploit it and fails to bring forth the quantity needed, the price is unwisely low, even if it does square perfectly with somebody's idea of return on a "rate base." The problem, of course, is to know what price level will be adequate to perform this economic function.

* * * * *

[615]

I should like to reverse this case, not because I think the rate reduction is wrong, but because I think the real inwardness of the gas business as affects the future has been obscured by *the Commission's preoccupation with bookkeeping* and historical matter. Such considerations *may be relevant to rate-base theories, but will not be very satisfying to a coming generation that will look back and judge our present regulatory method in the light of an exhausted and largely wasted gas supply.* * * *

PETITIONER'S BRIEF

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PERMIAN BASIN AREA RATE CASES

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE SUPERIOR OIL COMPANY

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1967

NOS. 90, 95, 98-102, 105, 117, 181
PERMIAN BASIN AREA RATE CASES

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE SUPERIOR OIL COMPANY

OPINIONS BELOW

The opinion of the Court of Appeals for the Tenth Circuit, *sub nom Skelly Oil Company, et al.*, Petitioners, v. *Federal Power Commission,* Respondent, Nos. 8385, et al. [No. 8510], and the opinion on Motion for Rehearing are reported at 375 F. 2d 6 (XII R. 15-61 and XII R. 87-89). The opinion and orders of the Federal Power Commission herein styled *Area Rate Proceeding Dockets No. AR61-1, et al.,* are reported at 34 FPC 159, with denials of rehearing and modifications at 34 FPC 1068, 1082, 1198, shown in the Joint Appendix printed for the use of the court below as follows: R. 516d-826d, R. 1105d-1132d, R. 1156d-1157d.

JURISDICTION

The judgment of the Court of Appeals was entered January 20, 1967: Certain petitions for rehearing were granted in part and refused in part by opinion entered April 18, 1967. Jurisdiction of this Court is invoked under 28 U.S.C.

Sec. 1254 (1) and Section 19(b) of the *Natural Gas Act*, 15 U.S.C. 717r(b).

QUESTIONS PRESENTED

1. Is there a constitutional or statutory bar to determination of just and reasonable rates for a natural gas company under the *Act* on the basis of group composited costs?

2. If the *Act* permits the fixing of rates for a natural gas company on the basis of composite cost determination for a group, does the *Act* as so applied not violate Article I, Section 1, of the *Constitution of the United States* in that it fails to provide any standard whatsoever for the selection, composition or make-up of such group?

3. Where the regulatory agency without evidence or hearing selects a group of natural gas companies for regulation of the rates of each on the basis of group composite cost, and precludes any contention that the group selected may be inappropriate for such purpose, is not a natural gas company aggrieved by the rate so fixed for it deprived of due process of law under the *Fifth Amendment to the Constitution of the United States*?

4. Does a gas producer, regulated as a natural gas company under the *Act*, have a constitutional and statutory right to be reimbused for all expenses, including *dry hole expenses* reasonably incurred in finding and producing natural gas sold subject to said act?

5. Whether the Commission was required to specify as part of the hearing procedure the circumstances and method by which a producer would be granted exceptions from area rates and whether the Commission must, as a matter of law, stay the application of those rates where the Commis-

sion has failed to provide a meaningful exception procedure at the hearing stage.

6. Whether the Commission properly imposed a refund obligation under Section 4 of the *Act* for those years where group revenues from the area return less than the composite area cost of service and whether the Commission in ordering refunds for individual respondents may totally ignore all equitable considerations.

7. Whether the Commission has authority under the *Act* to order restitution of sums in excess of the amounts subject to refund where the just and reasonable rate is found to be less than the last firm rate in effect not subject to any refund obligation under Section 4 of the *Act*.

CONSTITUTIONAL PROVISIONS AND STATUTES INVOLVED

The constitutional provisions involved are Article I, Section 1, of the *Constitution*, and the *Fifth Amendment to the Constitution*. The statute involved is the *Natural Gas Act*, June 21, 1938, c. 556, 52 Stat. 821-833, as amended, 15 U.S.C. 717-717w, and particularly Sections 2, 4, 5, 7 and 16 thereof. The pertintent portions of the respective provisions of the *Constitution* and the statute are set forth in Appendix "A" hereof.

STATEMENT OF THE CASE

This proceeding represents the Commission's first attempt at group rate fixing under the *Act*, and presents to this Court the opportunity for review of such effort for the first time.

The Federal Power Commission initiated this proceeding in 1960 to establish maximum just and reasonable rates for interstate sales by independent producers of natural

gas in the Permian Basin Area of western Texas and southeastern New Mexico. In 1965, the Commission issued its decision prescribing area rates and rendering various incidental rulings and orders collateral thereto. On review, the Court of Appeals for the Tenth Circuit sustained in part and set aside in part the Commission's orders.

The geographical area, the so-called Permian Basin Area, encompassed separate pricing areas delineated in the *Commission's Statement of General Policy 61-1,* 24 FPC 818. It included (1) the so-called Permian Basin Area of New Mexico — three entire counties; (2) that in Texas Railroad Commission District 7-C — fourteen entire counties; and (3) that in Texas Railroad Commission District No. 8 — forty-one entire counties. The *Policy Statement* had recognized that the areas there established might ultimately be found inappropriate as pricing areas, 24 FPC 818, 819, although the guideline prices announced for the separate areas were the same.

The companies selected for regulation as a group included all natural gas companies classified as independent producers under said *Act* making jurisdictional sales within any part of the so-called Permian Basin Area.

The Commission order invoking this hearing specifically provided that issues or contentions that the geographical area selected, and the resulting group composition, were not appropriate for group rate making purposes would not be entertained because such consideration might delay the final determination of rates. Order issued December 23, 1960 (R. 1d.-3d).

By subsequent Order of August 2, 1961 (R. 38d-46d) as amended January 11, 1962 (R. 62d-65d), the Commission directed respondents to complete and submit certain data forms; i.e. Appendix A — "Operating Data" (all respond-

ents); Appendix B — "Cost and Statistics Pertaining to Oil and Gas Production, Exploration, Gas Gathering and Products Extraction Operations, Year 1960" (respondents with companywide jurisdictional sales of 10 Million Mcf or more); and Appendix C — "Costs and Statistics Pertaining to Oil and Gas Production and Exploration — Small Producers, Year 1960".

The Commission's Order of April 5, 1961 (R. 29d-32d) specifically ruled that rate base cost of service studies for individual producers or groups of producers could not be introduced in evidence in this proceeding.[1]

The Commission held in *Opinion No. 468* (R. 516d-826d) that while Section 4(a) of the *Act* requires that all rates and charges of *any* natural gas company shall be just and reasonable, nothing in the *Act* states or suggests that such rates cannot be determined in group or on an area basis rather than in individual proceedings (R. 543d-544d); that constitutional restrictions and statutory powers should be considered in the light of the particular problem and what is necessary for a "sensible" result (R. 545d-546d). The Commission found that rates based on individual cost experience could be either too high for consumers in relation to other available supplies, or too low to be fair to the regulated producers considering their risks. The Commission also found that since profits in the aggregate would be at a reasonable level, that group cost-based rates would be fair to all although individual returns thereunder would vary greatly (R. 547d-548d); and finally that group rate fixing under this *Act* is legal as *other* price regulatory acts do not require consideration of rates related to individual costs (R. 543d-546d).

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[1] See also Order of August 2, 1961 (R. 38d at 41d and 42d) and Examiner's Opinion at R. 1905-1907.

The Court below held that no prior judicial decision had passed on the question of legality of group rate fixing under this *Act*,[2] but noted that group rate regulation had been sustained under other statutes.[3] The Court assumed that the Congressional requirement for rate regulation must have intended use of any method by which that end could be attained. Thus there was no abuse of discretion in here resorting to group price fixing since it was not specifically prohibited by the *Act* and there was no constitutional obstacle to such method.

The Court below further held that although the language of the *Act* in all pertinent clauses provided for regulation in the singular (R. 34-XII) and was entirely silent on group rate fixing, nevertheless it contained sufficiently definite standards to allow the Commission to select groups for rate making. Therefore, the Commission's action was not subject to objection under *Article I, Section 1, of the Constitution* as an unfettered delegation of legislative power, particularly since the Court was unconvinced that the Commission order precluding contest of the grouping for price regulation denied the producers any specific right (R. 34, 35-XII).

The Court also held that the end result of a just and reasonable rate established under the *Act* must be a rate

[2] R. 32-XII, pointing out that *Wisconsin* v. *Federal Power Commission*, 373 U.S. 294, 83 S.Ct. 1266 (1963), did not reach it nor did *United Gas Improvement* v. *Callery Properties, Inc. et al.* (Callery), 382 U.S. 223, 225-226; and holding that while *Bowles* v. *Willingham*, 321 U.S. 503, 517, (1944), held that individual rate making was required by the Natural Gas Act, such was dicta, the value of which was destroyed by *Second Phillips*.

[3] R-33-XII, *Interstate Commerce Act*, 49 U.S.C. § 15; *Packers & Stockyards Act of 1921*, 7 U.S.C. 181, *et seq.*; *Agricultural Marketing Agreement of 1937*, 7 U.S.C. 601, *et seq.*; *Bituminous Coal Conservation Act of 1937*, 15 U.S.C. 828-851; and state acts for regulation of insurance rates and control of milk prices.

that produces revenues sufficient to cover operating expense, capital costs, including service on the debt and dividends on the stock of the regulated enterprise. The return to the equity owner must be commensurate with that from investment in other enterprises with corresponding risks and sufficient to assure confidence in the financial integrity of the enterprise and maintenance of its credit and ability to attract capital (R. 37, 44, 45-XII).

The Court below reversed the Commission for failing to find that the group rate here established was sufficient to meet the above end result test for the group (R. 46-XII).

The Court held that expense items and dry hole expenses which might be included in an individual cost of service for determination of lawful rates was not the measure of a confiscatory rate because a gas producer has no obligation to remain in business or replenish its committed gas supply. Therefore the adverse impact of a group fixed rate on high cost producers, even though inevitable, does not destroy the area or group rate fixing method (R. 46-49-XII).

The Court also found that the Commission's provision for special relief from area rates was "so vague and nebulous that neither [the producers] nor a court can determine what relief is being granted", and holding that an "adequate savings clause should contain guidelines which if followed by an aggrieved producer will permit it to be heard promptly and to have a stay of the general rate order until its claim for exemption is decided" (R. 50-51-XII).

On rehearing, the Court concluded that no refund obligation could be imposed for any period in which there was a "group revenue deficiency". In fixing an area rate, the Commission must consider the effect which past and potential refunds have on balancing the group revenues with group revenue requirements" (R. 88-89-XII).

The further holding of the Court below on particular matters are here omitted as not pertinent to the questions posed.

The various appeals from the Decision of the Tenth Circuit below were consolidated as the "Permian Basin Area Rate Cases". These cases were consolidated for argument and the briefing schedule fixed by this Court on June 12, 1967.

SUMMARY OF ARGUMENT

We shall urge in this brief that the decision of the Court below should be sustained in part and reversed in part. In essence we urge that the Court below erred insofar as it affirmed the Commission's decision below with regard to the legality of group rate making and of the right of the Commission to exclude dry hole costs, but was correct insofar as it remanded the case to the Commission for further consideration of the question of refunds and the inclusion of an appropriate savings clause.

The *Natural Gas Act* does not provide for the fixing of rates on an area or group basis. For this reason, if area rate making is to be affirmed, the authority necessary for such a rate-making approach must be found to be in the *Act* by implication. Because the Commission in fixing rates has only such authority as is delegated to it by the legislative branch, the authority which may be given it by implication is of necessity primarily procedural rather than substantive. The Court may not supply that which Congress has failed to provide by way of regulatory standards and safeguards. The Commission which was sustained by the Court below has justified its group rate-making procedure solely on the basis of group rate making by other regulatory agencies; however, in each instance, these other regulatory agencies have found all of the necessary provisions for so-called group rate making within the specific provisions of

various Acts. In no instance has it been necessary for any authority to be granted to these agencies by implication or ingrafted from other Acts or in order to achieve complete and effective rate-making powers. Furthermore, each of the Acts relied upon by the Commission and the Court below to justify the group approach provides much more than mere authorization of group rate making. These Acts include provisions for the selection of the group, for the granting of relief to those whose position is atypical of the group, and in each instance provide a standard against which the regulatory result as to the group may be measured.

We shall urge that the Commission erred in its selection of a group and area to be regulated without evidence or hearing. That the result of such selection and the denial of opportunity to offer evidence to show that such group or area was inappropriate constitutes the denial of due process of law, for the result was foreordained by selection of the group and the area. Further, we shall urge that the Commission and the Court below are incorrect that dry hole expenses may be properly excluded in any determination of the confiscatory level.

While the Commission most certainly has the power to determine the manner in which such legitimate incurred expenses shall be recovered, it does not have the power under constitutional limitations to deny their recovery as either an item of current expense or as a capital recovery charge.

We shall urge that the Court below was correct in remanding to the Commission the issue of the inclusion of an appropriate savings clause. Further we shall show that the Commission's failure to provide during the course of the hearing a realistic and workable method for allowing the

individual respondent to show its exceptional circumstances constitutes a denial of due process and that the Court below erred in failing to set aside the Commission's decision for such reason.

We shall urge that the Court below was correct in remanding to the Commission the question of the proper measure of refunds. If group rate making is valid under the *Constitution* and the *Act*, then as a matter of law refunds may be required of the industry only for those test years where industry revenues exceed industry costs. Further, we shall urge that the Court below was correct that refunds must be determined with regard to individual respondents on an equitable basis, for in determining refund obligations, the Commission is performing a judicial rather than a legislative function.

Finally, we shall urge that California is incorrect in its contention that the Commission has power to order reparations. Refunds, if ordered, are by the express provisions of the *Act* limited to the incremental increase subject to the Commission's suspension powers under section 4 of the *Act*.

I.

ARGUMENT
THE NATURAL GAS ACT PRECLUDES GROUP RATE FIXING

The Court below held that necessities of procedure and administration have led to regulation of the natural gas industry on an area rate method and that the Commission did not abuse its discretion in using that method since it was not barred by provisions of the *Constitution* or statutes. It recognized that it was determining a question of first impression (R. 33-XII) but refused to consider group

rate fixing cases under other statutes as authority for like regulation under the *Natural Gas Act* because of the "treacherous business" of applying implications from one statute to a totally different one, *Federal Trade Commission* v. *Bunte Bros.*, 312 U.S. 349, 353. It acknowledged that from its definitions to its regulatory clauses (Secs. 2, 4, 5, 7) the *Natural Gas Act* speaks in the singular, to individual company rate regulation, but noted that Section 16 authorized orders "necessary or appropriate to carry out the provisions of this Act". It bottomed its holding on the view that Congress intended effective regulation and thus must have intended *any* method of determining just and reasonable rates for the industry by which that task could be performed.

Preliminarily we point to several matters as to which we believe there is no dispute, i.e.:

(a) In enacting the Natural Gas Act Congress intended to provide for "regulation along recognized and more or less standardized lines", H. Rep. No. 709, 75th Congress, First Session, p. 3; FPC Brief P. 46.

(b) An administrative agency may exercise only the authority expressly or impliedly granted it by Congress, *Social Security Board* v. *Nierotko* (1946), 327 U.S. 358, 369; *East Texas Motor Freight Lines, Inc.* v. *Frozen Food Express* (1956), 351 U.S. 49, 54; *United States* v. *Fort Belknap Irrigation District* (D. Mont. 1961), 197 F. Supp. 813, 822; and see *National Labor Relations Board* v. *Brown*, 380 U.S. 278, 291, and has no inherent legislative power.

(c) The "just and reasonable" rate standard of the Natural Gas Act is identical with the "just and compensation" requirement of the Fifth Amendment.

Federal Power Commission v. *Natural Gas Pipeline Co.*, 315 U.S. 575.

(d) While the Natural Gas Act does not require use of any single method for rate determination, the end result of the method or methods used must produce a rate which "from the company point of view" will yield sufficient revenues "not only for operating expenses but also for the capital costs of the business" which include "service on the debt and dividends on the stock". *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. at 602; see also *Colorado Interstate Gas Company* v. *Federal Power Commission*, 324 U.S. 581.

(e) While cost of service is not a *sine qua non* of natural gas company rate regulation, neither consumers nor producers can be deprived "of their right to a just and reasonable rate", *Wisconsin* v. *Federal Power Commission*, 373 U.S. 294.

In its opinion the court below conceded that if the words of Section 4(a) of the *Act* * * * "all rates * * * made * * * by any natural gas company * * * shall be just and reasonable" means that each producer is entitled to a rate just and reasonable to it, the inquiry is at end, and the area rate-method is invalid (R. 34-35 XII). It is submitted that the court erred in finding that the quoted words do not have just such meaning, particularly in the context of the balance of the Natural Gas Act and the declared intention of Congress mentioned above. Justice Douglas, who wrote the opinion in *Hope, supra,* came to the exact conclusion in *Bowles* v. *Willingham*, 321 U.S. 503.

The Federal Power Commission Brief points to the fact that this Court in *Wisconsin* v. *Federal Power Commission*, 373 U.S. 294, *(Second Phillips)* did not find that the

Commission was abusing its discretion by experimenting with area regulation of producers' sales. Perhaps rates based on "the reasonable financial requirements of the industry in each producing area" might possibly yield a rate to each producer in the area which is just and reasonable. But here, as the court below found, the area rate method result covers the entire range from "bonanza to bankruptcy" (R. 36 XII) for the individual producers in the area, and except by chance the costs of *"any"* natural gas company will not equate to the area determined rate called just and reasonable, and even then will so equate only for one of many years (FPC Brief P. 55).

It seems beyond controversy that a method of rate making which yields a just and reasonable rate to any natural gas company merely by chance and then only fleetingly, does not meet a standard that declares any rate of *any* company that is not just and reasonable at any time unlawful. To so say goes beyond construction of the English language to distortion of words. The *Act* by its terms requires that the justness and reasonableness of each particular natural gas company's rates be tested with reference to that individual seller's circumstances and operations. Section 2 defines "person" as an individual or corporation, and the term "natural gas company" as a person transporting interstate or selling natural gas in interstate commerce for resale. Each reference[4] in Section 4 and 5 of the *Act* the natural gas company is in the singular, and while Section 5 authorizes the investigation of rates, the finding with respect to just and reasonable must be with regard to "any" rate of "any" natural gas company. "Any" means "every" or each "one out of all."[5] Further, the constitutional right

[4] And see opinion of the court below (R. 34 XII) for some elaboration of said wording.

[5] Webster's New International Dictionary, 2nd Ed., p. 121 and 742.

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to "just compensation" goes to individual companies or persons.

In each instance where this Court has been called upon to pass upon the constitutionality and legality of the Commission's actions under the *Act*, it has done so within the context of the *Act's* application to individual entities.[6] Here, in seeking to construe the *Act* as authorizing group rate making, the Commission has introduced constitutional questions not presented in any prior proceedings which determined rates on an individual basis. Contrary to the holding below the *Act* and the *Fifth Amendment* require individual rate making for natural gas companies.

The Commission urges as it has in the past the great difficulty of regulation of independent producers under the *Act*, and as stated in *Second Phillips, supra*, the task within the framework of the *Act* may be impossible if the Commission must proceed on a case-by-case, company-by-company basis. If this is in fact so, it is a problem for Congress. Difficulty of administration in enforcing regulations under an Act of Congress does not justify a procedural or administrative method which results in a violation of the *Act* itself.[7]

It was maintained above that the experiment in area or group rate making under this *Act* raises constitutional questions never before passed on by this Court. Accepting

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[6] In *Bowles* v. *Willingham*, 321 U.S. 503, Justice Douglas distinguished the *Act* from *The Emergency Price Control Act of 1942*, 56 Stat. 23, on this very basis at the same time in which he had delivered for this Court the decision in *FPC* v. *Hope Natural Gas Co.*, 320 U.S. 591. Producers are beyond question "natural gas companies" under *Phillips* v. *Wisconsin*, 347 U.S. 672, otherwise they are not subject to regulations. The *Act* sets a single standard for regulation of "natural gas companies".

[7] *National Labor Relations Board* v. *Brown*, 380 U.S. 278, 291, 292.

that the fixing of just and reasonable rates involves a balancing of the investor and consumer interests, *Hope, supra,* 320 U.S. 591, 603; FPC Brief p. 39, it seems clear that a rate fixed by an area method at least as was done here for the producing industry cannot meet the test.

If the balancing of investor and consumer interests is the *sine qua non* of a "just and reasonable" rate under the *Act,* a rate method that precludes any such balance is inherently invalid. Reasonableness becomes an abstract and subjective standard fixed entirely by agency discretion, the proper application of which cannot be reviewed by the courts because there is no standard by which to judge whether the discretion was properly exercised or abused. As held in *District of Columbia Transit System* v. *Washington Metro Area Transportation Comm.,* 350 F. 2d 753 (CADC 1965), a rate fixed without particularized reference to the legitimate expenses of the regulated company "does not satisfy any standard of rate making" especially a "just and reasonable" standard, *ibid, p. 778.*

However, there is no investor interest in the industry as such. Investments are made in individual companies which together make up an industry. Certainly the investor in "A" company with a bankruptcy rate is not properly considered nor his interest balanced merely because another investor in "B" company has a bonanza rate. But more importantly the *Act* does not regulate industries, producing, pipeline or distribution, but *companies* in those industries.

A rate making procedure which produces a result which cannot be measured against the standards heretofore set forth in Hope can meet neither the constitutional standards nor those of the *Act.*

II.

GROUP RATE FIXING UNDER OTHER STATUTES CANNOT SUPPORT THE COMMISSION'S GROUP RATE-MAKING SCHEME

In support of the legality of the Commission's group rate making, the FPC Brief cites a broad range of regulatory activities, ranging from milk to coal to stockyards to airlines. In relying upon such regulatory standards as supporting the Commission's action in the proceeding below the Commission overlooks the obvious that in each instance the regulatory standard under which the agency acts is complete and is contained within the framework of the Act involved. The Acts cited cover the regulation of both monopolies and non-monopolies, provide for regulation under the standard of just and reasonable and other standards, and provide for both uniform and non-uniform rates. Of all of the Acts cited, the only Act which bears even faint resemblance to the area rate proceeding as undertaken by the Commission is the Interstate Commerce Act wherein it provides for the division of joint rates among carriers.

Granting that Congress intended regulation of natural gas companies to be effective, merely because it did not expressly prohibit group rate making is no reason for assuming it authorized group rate making in the face of language to the contrary. Congress obviously knew how to provide for group rate fixing long before the enactment of the *Natural Gas Act* in 1938. It specifically so provided in the *Transportation Act of 1920,* and has specifically done so in other Acts before and since the *Natural Gas Act,* but in these other statutes it provided much more.[8]

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[8] See *Agricultural Marketing Agreement Act of 1937,* 7 U.S.C. 601, *et seq.;* the *Bituminous Coal Act of 1937,* 15 U.S.C. 828-851; the *Emergency Price Control Act of 1942,* 56 Stat. 23.

In *Nebbia* v. *People of the State of New York*,[9] the standard of regulation was complete within the *Act*. This *Act* provided for the fixing *minimum* prices which would "best protect the milk industry in the state and insure a sufficient quantity of pure and wholesome milk . . . and be most in the public interest" (291 U.S. 502). Thus, in *Nebbia* they were concerned with neither the fixing of just and reasonable rates nor, for that matter, maximum rates at all. More importantly, however, the selection of the area to be regulated was specifically provided in that the groupings were to be "in the several localities and markets of the state". There can be no issue of confiscation of property under *minimum* price orders as *Nebbia*, nor can a regulated entity urge that the effect of a *minimum* price order would deny it an opportunity to earn a fair return on its investment.

In *United States* v. *Rock Royal Co-Op*, 307 U.S. 533, there is a similar situation involving marketing conditions for agricultural commodities so as to insure the farmers equivalent purchasing power. The statute does not involve in any way the just and reasonable standard, but rather employes a standard which will achieve parity of prices.

The Commission also relies on the regulations of the coal industry under the *Bituminous Coal Act of 1937*, 15 U.S.C. 828. Under this Act the make-up of the group is specifically provided by statute and its provision for the fixing of maximum and minimum prices on the basis of voluntary "codes". The *Bituminous Coal Act* had a twofold effect: the minimum price provisions prevented price cutting and are obviously fixed to allow a substantial portion of the group to earn a fair return. The maximum price which was allowed was fixed so as to allow any mine subject to the voluntary group a sufficient price so as

[9] 291 U.S. 502.

to yield a fair return on the fair value of the property employed in the mining operation.

The Commission likewise relies upon *The Packers and Stockyards Act of 1921*,[10] an Act which provides a rate fixing standard of "just and reasonable". Under this Act the grouping is established by the very nature of the stockyard operation. This Act specifically authorizes group rates within a stockyard because the stockyards "had bound themselves to maintain uniform charges, regardless of the differences in experience, skill, and industry" *Tagg Bros. & Moorhead, et al.* v. *United States, et al.*, 280 U.S. 420, 439. To the extent that *The Packers and Stockyards Act of 1921* provides regulation, it is important to note that it deals with voluntary groupings, and that these groups never had been, nor were they likely to in the future, in price competition with one another. In effect this Act recognizes that the groups have a substantial monopoly within any stockyard area, and in order to prevent unconscionable charges to the public, the maximum rates which these stockyards may charge are subject to regulation. Thus, while group rates were established due to the agreement of the regulated parties, the effect was the same as individual price regulation for the rate fixed for any one would be taken by all. *Tagg Bros. & Moorhead, et al.* v. *United States, et al, supra; Acker* v. *United States*, 298 U.S. 426.

The Commission also relies upon regulation of airlines, telegraph companies, steamship companies, under the just and reasonable standard. However, the Commission confuses group rate making in this instance with group hearings undertaken for the purpose of fixing "uniform prices" for the same service rendered by several carriers between

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[10] 7 U.S.C. 181, *et seq.*

the same points. Under these circumstances, there is no necessity for determining the group or specifying the group composition in the statute. If the investigation is to determine the just and reasonable rates for telephone service between New York and San Francisco, the inquiry is of necessity limited to those that supply such service. If the inquiry is with regard to charge for air travel between New York and Miami, only those carriers directly concerned and certificated to fly such route would be respondents in a hearing before the Civil Aeronautics Board.

However, the Commission's reliance upon the Federal Communications Commission is particularly misplaced because of the standard employed by the FCC in fixing the rate of return to be allowed on services. In *Postal Telegraph-Cable, et al.*, and *Western Union Telegraph Co.*[11] relied upon by the Commission, there was involved the fixing of charges for handling point-to-point telegraph traffic. In the more recent case, *Western Union*, some ten carriers were involved. The FCC prescribed new land line divisions and new rates for international carriers. In connection with this investigation, the Commission reviewed the earnings of certain carriers in order to determine if these carriers were able to absorb the possible decreases in earnings as a result of the reduction of their share of the joint charges under the new divisions. The Commission rejected an industry-wide rate base and a fair rate of return for the group as a standard. Rather it took the experience of RCAC as the "bellwether" since it was the most profitable general service carrier, 25 FCC at 583. Since RCAC was the most profitable, the effect was to allow all other carriers a rate of return less than the 8½ percent allowed to RCAC. The FCC justified its actions in the language

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[11] *Postal Telegraph-Cable, et al.*, 5 FCC 524 (1938); *The Western Union Telegraph Co.*, 25 FCC 535 (1958).

cited by the FPC Brief P. 47 to the effect that the Commission was under no duty to fix rates so that all carriers might earn a fair return on the fair value of their property or even make some profit on their operations. But the Commission overlooks the most important element of the decision which is that *all of the carriers were not required in order to provide adequate facilities* at reasonable charges, which it was that Commission's duty to assure were provided under that Act. The FCC found, therefore, that it was under no duty to subsidize the less profitable carriers whose facilities in effect were superfluous. On the other hand, the carriers were not required to continue service and had the choice of seeking to improve efficiency and to remain in competition or withdraw from the market.[12]

The purpose of the Communications Act is, as interpreted by the Federal Communications Commission, not only create a monopoly but to assure that such monopoly is preserved. This position is in sharp contrast with the standards of the *Natural Gas Act* which require a fair return on the property committed to interstate commerce by the producer until such properties are depleted "or the public convenience and necessity requires the termination of service".[13] There is no evidence, no contention, no finding or even suggestion that the public convenience and necessity requires that all producers whose costs exceed the average of the unsifted costs of all respondents withdraw from exploration and development of natural gas for sale in interstate commerce. If this is the desired but unannounced intent of the Commission's area rate proceedings, then the effect upon the consumer will be catastrophic.

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[12] However the FCC did provide a savings clause.
[13] 15 U.S.C. 717f.

The regulation of the FCC may be contrasted with the regulation of the Federal Maritime Board and the Civil Aeronautics Board. Rather than using the bellwether, the Federal Maritime Board has resorted to a dominant carrier as the touchstone for setting rates to be observed by all carriers operating between the fixed points. In a 1957 decision, *Pacific Coast/Hawaii,*[14] the Federal Maritime Board chose Matson as the dominant carrier and determined a rate of return which would be just and reasonable for Matson. But the Federal Maritime Board did not stop with a mere determination of a single rate of return to be applied to Matson; rather it chose a range of return from 7.8 percent to 9.3 percent which it then applied to various rate bases from approximately $36,000,000 to $43,000,000. The Board's conclusion in the *Pacific Coast/Hawaii* investigation was that far from the proposed rate increase being too high, that it was not high enough and increased the proposed 6.9 percent increase on pineapple to 13.2 percent.

The Federal Martitime Board's group rate making does not support the action of the Commission below. The Board does not translate average costs into ceiling prices — rather it uses the dominant carrier which is fairly representative of a substantial segment of the industry and applies a rate of return to the rate base which is in a "reasonable range". Then to assure that the minority shippers are protected from unprofitable operation, Board makes pragmatic adjustments as in the case of the increase in the shipping cost of canned pineapple from 6.9 percent to 13.2 percent.

The Civil Aeronautics Board in the *General Passenger Fare Investigation*[15] followed a similar course to the Federal Maritime Board. Having no dominant carrier, the

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[14] *Pacific Coast/Hawaii and Atlantic Gulf/Hawaii General Increase in Rates,* 5 F.M.B. 347 (1957).

[15] *General Passenger-Fare Investigation,* 32 C.A.B. 291 (1958).

Commission lumped 12 carriers together which were in turn divided into the big 4 and the intermediate 8. This approach was characterized as the bulk line approach and is permitted under 49 U.S.C. 1482(e) subject to the proviso that the Board shall consider "the need of each air carrier for revenue sufficient to enable such air carrier . . . to provide adequate and efficient air carrier service". In this investigation the Board set the rate of return at the upper limits of the range of reasonableness since it was apparent that many of the member parent enterprises would fall below the line of the average rate of return (32 C.A.B. at 305). The Board determined that where the bulk of the carriers fell within a reasonable range, that the industry figures were not distorted by unrepresentative results and the carriers who are in extremely poor or extremely favorable situations, rather that the fare adjustment should be based upon the industry as a group (32 C.A.B. at 330). However, the Board felt that the rate of return adopted, since they were not minimum rates of return below which confiscation would result, were returns which were within the broad range of reasonableness and would be reasonable for all entities. The Board also makes refence to the other tools available to the Board to aid the unprofitable carriers who, even with a general fare increase, were still unable to provide adequate and efficient air carrier services. The tools available to the CAB are, of course, unavailable under the Act. This emphasizes the undesirability of attempting to transfer group rate making from one agency into a standard for another agency unless the entire Act, including all of the special provisions, exceptions and safeguards, are also utilized. Reliance upon these other Acts to support a group rate making under the *Act* is completely unfounded.

The FPC Brief also relies upon the provisions of the *Interstate Commerce Act*[16] to justify its group rate making. Specifically the reliance is upon Section 15(6) of the Act providing for the establishment of just divisions of joint rates, fares or charges. Section 15(6) requires that there be just, reasonable and equitable division of the joint rates which shall not unduly prefer or prejudice any of such participating carriers. While admittedly the division of joint rates under the *Interstate Commerce Act* comes closest to being analogous to the regulation of producers under the area proceedings, there are a number of differences between the two *Acts* as applied. There is, of course, no provision in the *Natural Gas Act* with regard to aggregate operating income on the aggregate of the natural gas industy's properties used in public service. More importantly, as discussed above, the *Interstate Commerce Act* is so worded that the selection of the groups is not within the Commission's discretion. Rather it is fixed by the statute and encompasses all carriers involved with the through or joint rates which are the subject matter of the hearing. Finally, this Court has interpreted that statute as requiring the provision for and the inclusion of the so-called savings clause as a necessary part of the proceeding and the Interstate Commerce Commission's orders resulting therefrom.

In *The New England Divisions Case,*[17] this Court was called upon to analyze the effects of the provisions added by the 1920 amendments to the Act. The Court found that the divisions were not required to be uniform and that the Act contemplated in effect taking from the rich and giving

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[16] 49 U.S.C. #1, *et seq.*

[17] *Akron, C. & Y. Ry. Co.* v. *United States,* 261 U.S. 184 (The New England Divisions Case).

to the poor. Justice Brandeis speaking for the Court stated with regard to the purpose of the Transportation Act of 1920:

> "It was necessary to avoid unduly burdensome rate increases and yet secure revenues adequate to satisfy the needs of the weak carriers. To accomplish this, two new devices were adopted: The group system of rate making and the division of joint rates in the public interest. Through the former, weak roads were to be helped by recapture from prosperous competitors of surplus revenues. Through the latter, the weak were to be helped by preventing needed revenue from passing to prosperous connections. Thus, by marshaling the revenues, partly through capital account, it was planned to distribute augmented earnings, largely in proportion to the carrier's needs" (261 U.S. at 191).

Justice Brandeis concluded that the provisions concerning divisions were an integral part of the machinery for distributing the funds to be raised by the new rate fixing sections. This Court held that Congress did not intend that the ICC hear specific evidence and make specific adjudications with respect to each division of each rate of each carrier, but rather that:

> ". . . if the Commission finds that evidence introduced is *typical* of traffic and operating conditions, and of the joint rates and divisions, of the carriers of a group, it may be accepted as prima facie evidence bearing upon the proper divisions of each joint rate of each carrier in that group" (261 U.S. at 199). (Emphasis supplied.)

Subject always to the inclusion of a proper savings clause and the necessary procedural safeguards.

> "Serious injustice to any carrier could be avoided by availing of the saving clause which allows anyone to except itself from the order in whole or in part on proper showing" (261 U.S. at 199).

This Court again reviewed the same provisions of the Interstate Commerce Act in *Beaumont, S. L. & W. Ry. Co. v. United States*, 282 U.S. 74, and expanded the doctrine of *The New England Division Case* by requiring that the carrier assume the burden of showing its entitlement to an exception at the hearing stage rather than on appeal, saying:

> "It is well-established by the decisions of this court that, in order to invoke such [Fifth Amendment] constitutional protection, the facts relied upon to prevent enforcement of rates prescribed by governmental authority must be specifically alleged, and from them it must clearly appear that the enforcement of the measure complained of will necessarily deny to the utility the just compensation safeguarded to it by the Constitution. *Aetna Insurance Co.* v. *Hyde*, 275 U.S. 440, 447, 448, . . . and cases cited. *Here the joint rates themselves are not assailed as too low, but the claim is that the prescribed divisions are confiscatory.* The same rules as to pleading and proof apply to orders prescribing divisions as to laws fixing rates. *There is no allegation in the complaint, or evidence in the record to show, that any division to any of the appellants will not yield operating expenses chargeable to the service covered by it plus a reasonable return on property value fairly attributable to that service*" (282 U.S. at 89). (Emphasis supplied.)

While sustaining the Commission's action, the Court reiterated its previous rule that the rates must be just and reasonable to all who are thereafter required to observe them, and that adequate provisions for demonstrating the exceptions to such rates by individual carriers must be afforded at the hearing stage.

During the last term of this Court, it passed upon a Commission order under Section 15(6) of the *Interstate*

Commerce Act.[18] In sustaining the action of the Commission and reversing the decision of the district court, the Court again reviewed the standards under Section 15(6) of the Act and reiterated the need for consideration of the regulated company individually even in an authorized group proceeding, holding:

> ". . . It has always been accepted that an individual carrier may challenge this premise and, on proper showing, receive independent consideration if its individual situation is so atypical that its inclusion in group consideration would be inappropriate" (Slip Op., p. 14).

However, the Court noted:

> ". . . at no point during the administrative hearings or the presentation of evidence did they raise any claim for separate treatment" (Slip Op., p. 15).

This Court found that the aggrieved carriers had waited too long to raise the issue of confiscation, but that the Commission was not required on its own motion to guess which of the 300 carriers might require individual treatment (p. 1605) when none of them even requested it. The aggrieved carriers argued that the Commission erred in generally treating them on a group basis and not making individual findings on their costs and individual needs, but it is clear that the decision rests on the fact that the carriers failed to show at the hearing stage that they would be aggrieved or would suffer injury under the Commission's revision of divisions in joint rates.[19]

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[18] 49 U.S.C. 15(6).

[19] The position of the aggrieved carriers is in sharp contract with the instant proceedings where producer respondents, including petitioner, insisted at the inception of the hearing on the adoption of a meaningful savings clause provision (R. 29d-38d). Superior's cost-of-service presentation shows that Superior's jurisdictional cost of service is in excess of its revenues on a companywide basis. Based upon such a showing, we urged to the Examiner and to the Court below that we were entitled as a matter of law to exception from the area ceiling rates.

We did not seek, nor do we seek now, rates fully equal to our cost of service. To any extent that our contract rates are less we are willing to carry out our bargains. However, we strongly contend that our bargained rates may not be reduced when as in *Second Phillips* they produce less revenue than our cost of service.

As pointed out by the Court below, the treacherous business of taking an *implication* drawn from one statute to a totally different statute which has different purposes and provisions (notwithstanding some similar or even identical parts) is well demonstrated. Where group regulation was expressly provided for in the statute or is properly implied from the wording or purpose of the legislation, there are invariably large differences in the total enactment. It was the unusual rather than the standard type of recognized regulation in 1938 when the *Act* was enacted. This *Act* by wording and intent was to provide for individual natural gas company regulation as Justice Douglas stated in *Bowles* v. *Willingham, supra.* No other construction is warranted.

III.

THE RATES FIXED ARE CONSTITUTIONALLY DEFICIENT

In discussing cases arising under other statutes we pointed to the fact that the statutes themselves expressly provided for group determination where group rates were permitted. Certainly it is not even contended that the *Act* has any such provision.

Statutes which permit group rate making, or fixing uniform rates for groups, prescribe standards for fixing the rates, selecting the group, and, in most instances, methods by which the agency can ameliorate the effects of the application of uniform rates to the individuals in the group. If the *Act* which lacks such standards is construed as impliedly authorizing group rate making, then the *Act* itself is contrary to Article I, Section 1 of the *Constitution of the United States*. This section invests all federal legislative authority in Congress. In all instances where agencies regulate rates they do so under legislative authority delegated by Congress or the various state legislatures. Such regulatory agencies have no inherent power. Such power as they have is limited to that delegated, which must be accompanied by the laying down of policy and the establishment of standards for its exercise. An attempt by Congress to delegate legislative power is void where Congress has "established no standard, has laid down no rule" *(Panama Refining Co.* v. *Ryan;* 293 U.S. 388).[20]

It is here contended that by implication, the *Act* permits group rate making. We disagree on the ground that such

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[20] ". . . In every case in which the question has been raised, the Court has recognized that there are limits of delegation which there is no constitutional authority to transcend" (293 U.S. at 430).

implication is forbidding by the very terms of the *Act*. But assuming this is not the case all parties agree that the makeup of such group must be reasonable. As discussed above those supporting the Commission's area rate experiment cite the operation of many other agencies regulating groups of individuals under similar and dissimiliar standards as supporting the Commission's action in the proceeding below. If the standard of the Commission's action is reasonableness, then each and every step in the proceeding must also be reasonable. The Commission determined the area which would be encompassed by its initial rate hearing (R. 2d IX) which provided that the geographical area should consist of the Permian Basin of New Mexico and Texas Railroad Commission Districts Nos. 7(c) and 8. There was, in fact, no selection of a grouping, but rather the inclusion of all those selling in interstate commercial natural gas within the area as the group. Thus, the grouping of the companies whose rates were to be fixed arises entirely without rhyme or reason, or without explanation of any kind. But more importantly, the areas selected, and thus the grouping, although acknowledgedly subject to question, were placed beyond the issues and controversies in the proceeding. The Commission stated:

> "We have concluded that no useful purpose would be served at this time by delaying the discharge of our primary responsibility under the Act of determining just and reasonable rates by entertaining issues or considering contentions that the areas we have delineated in our Statement might be inappropriate for rate making purposes. Accordingly, for the purposes of this area proceeding we do not propose to consider any evidence looking toward the fixing of rates for sales of gas in areas outside the boundaries of the

geographical area we have delineated in Appendix 'D' hereto" (R. 3d IX).[21]

As there is absolutely no legislative standard in the *Act* for the selection of the group, the result is predetermined by the arbitrary selection of the group by the Commission by proscribing the admission of any evidence with regard to the area. The group could be neither expanded nor contracted, and, for this reason, the final result even if otherwise supportable as just and reasonable, constitutes a denial of due process.

Whenever costs are used in regulation, the validity of the use of averages is dependent upon a "close resemblance of the individual members of each group on the essential point or points which determine the costs considered" *(U. S.* v. *Borden Co.,* 370 U.S. 460, 469). It is uncontested that the characteristics of the various members of the group are quite dissimilar. Thus for group rate making to meet the constitutional standards, there must be a group whose characteristics are essentially similar. A reasonable group could include only companies with production from the same or equivalent depth with wells drilled at approximately the same time in the past, or with drilling costs

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[21] The Commission's action in Permian may be contrasted with the notice provided in later area proceedings such as the Texas Gulf Coast and the Hugoton-Anadarko. The order there (30 FPC 1354, 1357) stated:

> "The investigation will encompass not only issues related to the establishment of particular area rates, for the future, but will also consider whether such area rates should be uniform throughout separate production areas which are being consolidated for joint hearing, or should vary from different production areas or for any other geographical area encompassed within the proceeding. The Commission will accept and consider petitions by any party to either proceeding filed within three months of this order (and served upon all other parties thereto) seeking to enlarge the areas to be considered in either proceeding."

adjusted for changes in per foot cost of drilling over a period of time. By defining the multi-state area the group consisted of high cost producers and low cost producers. The unsifted average costs were directly translated into ceiling prices. The lumping of all producers in the broad area, including those that drilled the old shallow and relatively inexpensive wells and those that drilled the newer deeper and more expensive wells, could have but one effect. The rates of the active aggressive wildcat companies will be reduced in order to supply a windfall for those companies that are little better than in a liquidating posture.

Neither in its order, nor in its decision, has the Commission ever justified the aggregation other than it is a well-known producing area. Yet the record is clear that it is an area from which production varies from 7,000 feet in Nolan County, Texas to 25,000 feet in Reeves and Pecos County Texas. The evidence is uncontroverted that there has been a general increase in cost of drilling over the long run. It is also uncontroverted that the cost of drilling goes up expotentially with depth and that doubling the depth of a well may increase the cost fourfold. Companies such as Superior which are arbitrarily lumped in the group and who have drilled relatively deeper wells and with substantially all of their production of recent vintage will have higher costs than the group irrespective of prudence efficiency and even reasonably good fortune. The selection of the area which in turn controlled the group, coupled with the direct translation of group average costs into ceiling prices, is unlawful as a matter of law.

As indicated above, individual cost of service need not be the *sine qua non* of natural gas company regulation but any other method used must produce at least equal rates. Such method is certainly a proper method of determining just and reasonable rates *(Hope, supra, Colorado Inter-*

state, supra. The producers, any, each, and every one, have a right to a just and reasonable rate. *Natural Gas Pipeline Co., supra, and Second Phillips, supra.*

Nor does this requirement present the horrendous problem posed by the FPC Brief P. 54, anticipated by Justice Clark dissenting in *Second Phillips*. Regardless of its cost of service, no producer can obtain rates or prices higher than a competitive market level (between producers in the supplying market and between competing fuels in the consumer market). But to the extent the producer within a market has negotiated prices higher than average cost-based rates, those prices may not be *reduced* by regulation if a non-confiscatory rate for that producer is greater than the average cost-based rate. Confication does not result from voluntary acceptance of a price which will not return costs, *Covington and Lexington Turnpike Co.* v. *Sanford; et al.*, 164 U.S. 578, and *Federal Power Com.* v. *Sierra*, 350 U.S. 348. Rather confiscation results from governmental compulsion requiring less than just compensation.

The FPC Brief P. 54 points to the intolerable administrative burden of regulating the many producers. This burden seems completely bearable for some ninety-odd pipeline companies, each of whom are natural gas companies governed by the same statute as producers. They are individually regulated. The Commission seems to have determined that small producers, the largest member of the total, need only minimal regulation, and to have fixed as its regulatory target the larger producers who number considerably less than presently regulated pipeline companies.

It is rather strange that the Commission is embarking on this experiment, while placing great emphasis on cases arising under the Interstate Commerce Commission notwithstanding differences in the two statutes, does not consider the purpose and effect of the Transportation Act of 1920. As stated in the *New England Divisions case, supra*, the purpose was to preserve the weaker or a higher cost

company by taking from the stronger or a lower cost company revenues in amounts which would prevent confiscation to either.[22] This purpose was to be achieved primarily by "equitable divisions" of joint rates. In a truly representative situation (group to separate members) such as the dominant carrier or bulk line approach could solve the "bonanza to bankruptcy" result and related constitutional and statutory problems. It would certainly answer in a large measure the intolerable administrative burden the Commission complains of, permit efficient and practical regulations and at the same time protect the regulated natural gas companies in the producing field from being deprived of their property without just compensation. Some exceptions or exemptions might still be required as in the Interstate Commerce Commission procedure, but such would be relatively few compared with the present experimental monstrosity.

IV.

A MEANINGFUL AND WORKABLE SAVINGS CLAUSE MUST BE INCLUDED IN ANY VALID RATE ORDER

The Tenth Circuit was correct in its decision to remand Opinion No. 468 to the Commission for the determination and inclusion of a workable and meaningful savings clause for the protection of those producer respondents, including petitioner Superior, who were denied the opportunity during the hearing stage to demonstrate why they were entitled to an exception from the Commission's area ceiling prices. The FPC Brief P. 66 urges that petitioner is not aggrieved by the Commission's failure to specify in greater detail than it did the conditions under which exceptions to an area rate would be allowed. Said brief cites among others *The New England Divisions case, supra.* Of course this case

[22] 261 U.S.C. at 191.

does not support this position whatsoever, but rather affirms the Commission's error in failing to provide a mechanism throughout the hearing stage for proof of the need for an exception.

It is also contended that the Commission is not required to stay application of an area rate where a natural gas company seeks an exception. This position is shocking under the circumstances. In brief, it is an argument that respondents should have known in an admittedly evolutionary proceeding the precise manner in which regulation on an area basis would evolve. It also assumes that such respondents were derelict in failing to make a proper evidenciary showing notwithstanding the fact that the Commission repeatedly stated that individual presentations would not be permitted.

Fundamentally, however, this argument arises from the failure to recognize the real nature of the certificate of public convenience and necessity and the rights of holders thereunder. While the producer is not required to commit natural gas into interstate commerce, having once voluntarily done so, even under mistake[23] of fact he is thereafter required to observe all the rules and regulations promulgated by the Commission under the Act. The sole basis for discontinuance of service under the Act by an independent producer is the exhaustion of natural gas which is the subject matter of the sale or the requirements of the public convenience and necessity. So long as the producer is a natural gas company and performs the acts required of it under its certificate of public convenience and necessity, it is entitled to all of the protection afforded under the

[23] The Commission has treated sales for compressor fuel as jurisdictional and required retroactive certificates for such sales based upon the Lo-Vaca Doctrine, *People of the State of California, et al.* v. *Lo-Vaca Gathering Company, et al.*, 379 U.S. 366.

Act and under the *Constitution*, including a fair return on its property committed to public service.

What is urged in fact is that the nature and character of the public convenience and necessity be changed so as to deny for the period of time between the effective date of the Commissions's order herein and the conclusion of hearings on the exception, the *right* to the individual natural gas company to earn a fair return on its property. Thus the Commission would seek to do by indirection two things which it is not allowed to do directly, i.e., (1) require the abandonment of service prior to the exhaustion of natural gas in the total absence of any showing that such abandonment is in the public convenience and necessity; (2) deprive the producer of his right to a just and reasonable rate.

The Solicitor of the Federal Power Commission in oral argument before this Court in *Second Phillips* stated in response to a question from this Court that if the Commission did not allow exceptions to area rates for those whose costs exceed the average cost, that the Commission "would just have to let them go out of the interstate business." That is, the Commission would enter an order in the alternative that the natural gas company would either (1) thereafter observe the ceiling price, or (2) discontinue sales in interstate commerce. These alternatives have repeatedly been suggested by the Staff of the Commission at the hearing stage, before the Commission and on appeal. They urge this as the perfect solution to the dilemma which they see the Commission facing — if producers don't like it, they can lump it.[24]

The Commission would use Section 5 of the *Act* to terminate a certificate of public convenience and necessity

[24] Perhaps it should be "Let them eat cake . . ." But there are but few scraps from the feast table of the high return producers with their old, shallow, low-cost properties.

without regard for the requirements of abandonment set out in Section 7 of the *Act*. This the Commission cannot do for the rights granted under certificates of public convenience and necessity issued under all Acts are recognized as valuable property rights. All agencies who have attempted to modify the express statutory provisions with regard to changes or modifications in certificates have found the powers sharply curtailed, and the courts have repeatedly admonished various other agencies for attempts to do indirectly that which they are not entitled to do directly.[25]

Abandonment under the Natural Gas Act comes only upon request of the regulated party, and there is no instance under the Act where the Commission on its own motion has sought to terminate service by any natural gas company. The Company may not by setting rates so low as to result in confiscation, but deny a savings clause, deprive a natural gas company of its right to a reasonable rate and thus destroy the economic value of the certificate of public convenience and necessity under the guise of rate making. The permissive character of a certificate does not give rise to any obligation on the part of a company to operate at a loss, and no contract that it will do so can be elicited from the acceptance of the certificate. Although their property is devoted to the public use, such commitment is on the condition and statutory provisions that the opportunity be afforded to earn a just and reasonable rate.[26]

The opportunity to earn a fair return may not be present as in the *Market St. Ry. Co.* v. *Railroad Comm'n of State of California*, 324 U.S. 548 (1945), rehearing den.

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[25] See *United Airlines, Inc.* v. *C.A.B.*, 198 F. 2d 100 (7th Cir. 1952); *U. S.* v. *Rock Island Motor Transit*, 340 U.S. 419.

[26] *Railroad Commission of Texas, et al.* v. *E. Texas Railroad Company*, 264 U.S. 79.

324 U.S. 890 (1945), and *Lexington Turnpike, supra,* cases. The over-all economic conditions or particular available markets may be such that at no rate level will there be revenues sufficient to allow the regulated entity to earn a fair return on its investment. But it is only in the absence of an opportunity to earn a fair return on the investment that abandonment is an alternative which the regulated entity may seek. If the opportunity to a fair return is present (and such opportunity is beyond doubt available here as the Commission order would reduce rates reached at arm's length), such an opportunity must be given to the regulated entity to the full extent of the just and reasonable rate. This is the only standard under any of the Acts providing for individual or group rate making by regulatory agencies. In fact, there appears to be only one instance where an agency has suggested that the rates to be fixed would result in a return substantially below that that the agency found to be reasonable. However, in the *Western Union, supra,* proceeding relied upon by the Commission in the decision below and in its brief, the order of the FCC (25 FCC at 639), provided that any entity might file tariff schedules on the statutory 30 days notice reflecting rates higher than those authorized for RCAC, the bellwether company. However, that Commission specifically recognized that the effect of that savings clause would be sharply curtailed by economic considerations, for the higher rates if allowed for those earning a return less than the bellwether could only result in a reduction in traffic and, in fact, less rather than more revenue.

No limitation on the opportunity to earn, within contract limits, exists with respect to sales in the Permian Basin Area. There is not one word of testimony by any party to the proceeding that any pipeline was unable to pay any of the rates in effect under its various purchase contracts which were consolidated by the Commission for

hearing. Nor did any responsible party urge that a single uniform rate was required at which all gas of a similar type would be sold. As the *opportunity* to earn is present it must be afforded the regulated natural gas company and at this *opportunity* must not be confused with the fact that where opportunity is *lacking*, the regulating agency cannot assure an adequate return.

V.

PRODUCERS HAVE A CONSTITUTIONAL AND STATUTORY RIGHT TO BE REIMBURSED FOR ALL EXPENSES INCLUDING DRY HOLE EXPENSES

The Commission urges in its Brief, page 25, that since the Commission does not authorize exploration, it is not accountable for fruitless exploration. The Commission had held (R. 658d) with regard to the cost which would be allowed under any savings clause that the amount which would be allowed would be limited. While the Commission stated that it could not specify all of the special circumstances, it did state that it would not permit recovery of unsuccessful exploration and development costs.[27] The court below reversed the Commission on the savings clause provisions but seemingly affirms the Commission's statement that it may properly exclude dry hole costs in determining the confiscatory level. The court stated:

> ". . . We agree with the Commission that the expense items included in an individual cost-of-service

[27] However the Commission failed to specify the procedures by which a savings clause would operate and, for this reason, was reversed by the court below (R. 50-51, XII). Thus this issue may not properly be before this court. However the issue of the propriety of the exclusion of dry holes has been raised by the brief of other parties in opposition to Superior as well as by the statement of the court below and, for this reason, must be answered.

> are not the measure of a confiscatory rate. A producer has no constitutional right to be reimbursed for dry-hole expenses" (R. 49 XII).

The court further found that while on the one hand the producer had no obligation to remain in business by replenishing the supplies of gas, that ". . . Inability to continue exploration and development is not confiscation" (R. 49 XII). Thus the issue with regard to the exclusion of dry hole expense which was raised as a part of the exception to and the attack upon the saving clause was discussed by the court below in a different context, i.e., the legality of group rate making.

The *Act* and the *Constitution* preclude the imposition of any rate which will not yield the regulated entity revenues equal to such entity's costs and financial requirements. The *Act* and the *Constitution* condemn any method including group rate making and any rate fixed thereunder which may be reasonable as to such entity only at some time in the future, and then by mere change. This court has stated:

> "By long standing usage in the field of rate regulation the 'lowest reasonable rate' is one which is not confiscatory in the constitutional sense." *Federal Power Commission* v. *Natural Gas Pipeline Co.*, 315 U.S. 575, 585.

And the lowest reasonable rate is one that promotes and allows an ongoing business.

> "From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock." *Federal Power Commission* v. *Hope Natural Gas Company*, 320 U.S. 591, 603.

The argument has been made in each of the area proceedings that dry holes are not a legitimate item of expense. This is based totally upon an argument designed to deceive and confuse. Stated in its simplest terms, the argument is that dry holes incurred in the test year are a part of the over-all search for gas which will be sold in the future. This gas which is found as a result of the successful search may or may not be sold in interstate commerce. Thus the consumer may or may not benefit from the industry incurring such dry hole expense and thus the inclusion of such items are improper. Admittedly, the exclusion of dry holes from the rate base does not do away with the expense. The cost of dry holes is still there and must be paid for, and since the only flexible item is the rate of return allowed on rate base, the exclusion of dry hole expense simply reduces the effective rate of return by an amount sufficient to offset the dry hole expense which is not allowed.

But the confusion over the dry holes and their proper treatment in cost of service arises solely from a misunderstanding of the nature of the dry hole allowances as an item of expense in the test year. The industry almost uniformly for book purposes expenses *all* dry hole expenses, tangible or intangible, in the year incurred. It is argued that since the dry holes are expensed, when they are incurred somehow this miraculously provides a recoupment of the investment. This, of course, is patently impossible. The investment is recouped (and dry holes represent part of the total investment) only when the products provided by the over-all investment, i.e., the gas, are sold regardless of how the investment is treated on the books. The dry hole allowance in the test year, which admittedly reflects current experience, is but a proxy for the dry hole expense incurred in past year for gas of many different years vintage. The dry hole expense is not, therefore, an

item of current expense at all, but in truth represents a return of capital which was constructively committed in some previous period or periods.

No one contends that the dry hole expense incurred with respect to flowing gas is not a proper item of expense.[28] The fact that current dry hole experience is used as a proxy for past dry hole expense which is unrecovered does not in fact change the nature of the charge. The amount allowed as dry hole expense does not represent recoupment of part or all of the investment expenditures made in the test year because no revenues flows from test year expenditures. Therefore, the disallowance of dry hole expense in a cost-of-service presentation is not a disallowance of an item of current expense but in fact is a denial of a full return of capital committed to develope the gas sold in the test year.

The Court's below reliance on Columbus Gas[29] does not support its decision. There a state statute was involved which was struck down as being violative of the *Fourteenth Amendment.* The statute in its operation precluded the allowance in operating expenses of "amortization of the value of leaseholds and wells and equipment thereon." As stated above, the dry hole expense is in effect an amortization of the over-all cost of development. This Court held:

> "When the allowance has been fixed and has been charged to operating expenses, it will supply the answer to other questions in controversy now * * * *" (292 U.S. 398, 406).

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[28] The Staff Brief concedes this point: "Like all prospecting, exploring for natural gas is a highly risky and uncertain business. The same investment may yield a dry hole, a marginal well, a moderately productive well, or a bonanza, depending upon luck as much, perhaps, as on extraordinary skill" (p. 51).

[29] *Columbus Gas and Fuel Co.* v. *Public Utilities Commission of Ohio,* 292 U.S. 398.

Columbus Gas rather than supporting the Court below, supports the position of Petitioner Superior for it makes clear the rule that the regulatory agency may determine in its over-all costing technique whether an item of cost is to be recovered as an expense item or capitalized and recovered through depreciation. Columbus does not stand for the proposition that an item of expense can be excluded from recovery in both manners as the Commission claims it may do, and this Court so states:

> "To withhold from a public utility the privilege of including a depletion allowance among its operating expenses while confining it to a return of 6½ per cent. upon the value of its wasting assets, is to take its property away from it without due process of law, at least where the waste is inevitable and rapid. * * * * Plainly the state must either surrender the power to limit the return or else concede to the business a compensating privilege to preserve its capital intact" (pp. 404 and 405).

If the Commission is to disallow dry hole expense, it must return to the rate base the unamortized portion of the dry hole expense incurred in all prior years. Further, for all years subsequent to the test year and in all future rate proceedings, the Commission *must* permit full capitalization of all dry hole expenses fairly related to that portion of the newly developed supply committed to interstate commerce.

No one disputes that the producers must incur the exploration and development expenses, including dry hole costs. No one disputes or offered any evidence in the proceeding with regard to any individual entity or as to the industry which would show that the cost associated with the discovery and development of the gas moving in interstate commerce in the test year in any way reflects an im-

prudent or unnecessary investment. Since dry hole expenses are a legitimate item of total cost of supply, they must be recovered either as a return of capital or as an item of expense irrespective of the bookkeeping practices of the individual producers or of the industry. Any rate fixing method which excludes these items of expense leaves the producer and the industry with its capital impaired. In terms of *Hope*[30] there can be no balancing of investor and consumer interest nor for the reasonable financial requirements of the producer and the industry being met for the individual producers' property has clearly been taken for public use without just compensation.

VI.

THE COURT BELOW WAS CORRECT IN ITS TREATMENT OF THE QUESTION OF REFUNDS

The decision below originally held that refunds must be on a company-by-company and rate schedule-by-rate schedule basis and in its remand to the Federal Power Commission instructed the Commission to consider refunds on such a basis. On Motion for Rehearing the court was convinced that the previous holding was wrong as it was inconsistent with the end result test which required the equating of group revenues with group revenue requirements and held:

> "This modification of the opinion means that no refund obligation may be imposed for a period in which there is a group revenue deficiency. When group revenues exceed group revenue requirements, refunds may be ordered on some equitable contract-by-contract basis. In fixing an area rate, the Commission must consider the effect which past and potential refunds have on the balancing of group revenues with group revenue requirements" (R. 89-XII).

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[30] *Hope, supra.*

The Commission challenges this portion of the Order and their argument is set out at pages 92 through 99 of their Brief to which we now reply as Respondent on this issue.

The Tenth Circuit correctly recognized that in group rate making as with any other form of rate making, the Commission's function in fixing rates for the future differs from the Commission's function in ordering refunds. For this reason it prescribed an "equitable" basis for refunds. The Federal Power Commission Brief fails to recognize the differences in function between Section 5(a) and Section 4(e) of the *Act*.

The distinction between the quasi legislative function and the judicial function has been recognized by every jurisdiction and by all courts without exception. The distinction was pointed out by this Court in the *Arizona Grocery* case[31] where the question was whether reparations could be ordered where the alleged invalid rate was one prescribed by the Commission rather than one fixed by the carrier. This Court reviewed the development of regulation under the Interstate Commerce Commission contrasting the operation of rates under Commission regulation with the rules existing under common law. The Court noted that under the *Act of 1887*[32] the Interstate Commerce Commission did not have the power to prescribe a rate to be charged in the future.[33] Rather the carriers were forbidden to extract unreasonable rates. If past charges were found to be unjust or unreasonable, reparations could be ordered by the Commission. Thus the *Act of 1887* altered the common law by lodging with the Interstate Commerce Commission the judicial powers theretofore exercised by the courts of determining the justness and reasonableness of

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[31] *Arizona Grocery Co.* v. *Atchison, T. & S. F. Ry. Co.*, 284 U.S. 370.

[32] *Act of February 4, 1887*, 24 Stat. 379.

[33] Similar to operations under Section 5(a) of the *Natural Gas Act*.

rates charged during past periods.[34] The enforcement of the award of the Interstate Commerce Commission was relegated to the courts. Subsequently, the *Hepburn Act*[35] and the *Transportation Act*[36] changed the policy under the *Act of 1887* to give the Commission authority with regard to the fixing of rates for the future, similar to those provisions found in Section 5(a) of the *Act*. Specifically the Interstate Commerce Commission was given the authority to fix minimum and maximum limits within which a carrier's rates must fall. This Court stated:

> ". . . When under this mandate the Commission declares a specific rate to be the reasonable and lawful rate for the future, *it speaks as the Legislature, and its pronouncement has the force of a statute*" (p. 386). (Emphasis supplied.) *Arizona Grocery* v. *Atchison, T. &S. F. Ry. Co., supra.*

It was contended that any shipper could still challenge a rate clearly fixed within the maximum-minimum limits and upon a showing that such rates were unjust or unreasonable would be entitled to reparations from the shipper.

> ". . . This argument overlooks the fact that in declaring a maximum rate the Commission is exercising a delegated power legislative in character . . .
>
> "Specific rates prescribed for the future take the place of the legal tariff rates theretofore in force by the voluntary action of the carriers, and themselves become the legal rate . . . This is true because the

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[34] However the Interstate Commerce Commission had no power to prescribe the rate which would thereafter be charged, and the carrier was not bound to limit its rates in the future to those rates found to be just and reasonable during the past period.

[35] Exising effective provisions of this *Act* are found in Title 49 U.S.C. §§ 1-6, 11-20a, 26, 27, 142.

[36] Existing effective provisions of this *Act* are found in Title 49 U.S.C. §§ 1, 6, 11, 14-16, 18, 20, 41.

> Commission, in naming the rate, speaks in its quasi legislative capacity. The prescription of a maximum rate, or maximum and minimum rates, is a *legislative quality as is the fixing of a specified rate*" (pp. 387, 388). (Emphasis supplied.)

The court then noted that the Commission in determining the appropriateness of reparations must recognize that its function in ordering such reparation is quite different than its function in prescribing rates to be thereafter observed and stated:

> ". . . Where, as in this case, the Commission has made an order having a dual aspect, it may not in a subsequent proceeding, acting in its quasi judicial capacity, ignore its own pronouncement promulgated in its quasi legislative capacity and retroactively repeal its own enactment as to the reasonableness of the rate it has prescribed" (p. 389).

It is the same with the Commission here when it prescribes a maximum rate for the future, it is performing a quasi legislative function. When it is awarding refunds under Section 4(e) of the *Act,* it is performing a judicial function in which equitable considerations are an important consideration. The fact that the Federal Power Commission in ordering refunds is performing a judicial function precludes it is a *matter of law* from using group costing techniques as the sole basis of ordering refunds by individual respondents even if it could validly exercise its quasi legislative power in such a way.

A most important consideration is, of course, the equities. These obviously can be shown only as to individuals and not as to groups. The appropriateness of a refund requirement upon any individual respondent may only be determined by analysis of the particular circumstances of such individual respondent. The position of the FPC Brief on

this matter is particularly surprising in light of the Commission's announced position with regard to the question of refunds and its affirmation by the Fifth Circuit:

> "In this early stage of shaping policies covering refunds, the Commission has simply faced up to the existence of a serious problem: Perhaps because of procedures required by the Natural Gas Act but in any event through its own process, the Commission has created enormous funds subject to various equitable claims. From well-head to pipe-burner any or all of the distributors and users of United's natural gas may have equitable claims to the refunds. But overriding all claims is the public's interest in Commission procedures and processes that will produce reasonable rates . . . [37]

The Federal Power Commission is required to enter an order which will be fair to all, both the individual respondent required to make the refund as well as the pipeline distributors and, ultimately, the consuming public. Refunds cannot be created by any species of order which directly translates rates fixed on the basis of unsifted averages of the experience of the group into rates applicable for past periods for individual respondents. Rather the Commission must provide a method by which the standards as to each individual respondent are equitable, similar to those required for restitution. This Court in *Atlantic Coast Line Railroad Company* v. *State of Florida*[38] considered the question of the appropriateness of reparations for interim charges collected under admittedly invalid orders of the Interstate Commerce Commission which after remand

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[37] *Texas Eastern Transmission Corporation* v. *Federal Power Commission*, 357 F. 2d 232, 239 (5th Cir. 1966).

[38] 295 U.S. 301.

the Interstate Commerce Commission practically re-entered with proper evidentiary support. Refunds of 34 percent of the increased rates collected between the original rate order and the second order finally were ordered. It was urged by the shippers that since the first order was admittedly invalid, the proper rate until the second order became effective was the prior lower rate theretofore in effect although said prior rate was found non compensatory and discriminatory. The Supreme Court reversed and ordered that there be no refunds. The considerations underlying such order were stated as follows:

". . . A cause of action for restitution is a type of the broader cause of action for money had and received, a remedy which is equitable in origin and function. (Citations omitted.) The claimant, to prevail, must show that the money was received in such circumstances that the possessor will give offense to equity and good conscience if permitted to retain it . . ." (p. 309).

"The case up to this point has been dealt with on the assumption that the award upon restitution is to be for the whole demand or nothing. There is, however, a possibility between these two extremes, a possibility exemplified in the decree of the court below . . . We think the claim for restitution should have been rejected altogether . . ." (pp. 316, 317).

". . . *The field of inquiry is one in which the search for certainty is futile . . . There is a zone of reasonableness within which judgment is at large* . . . The claimants do not sustain the burden that is theirs by showing that the master set up a reasonable schedule. *They must show that the other schedule, the one set up by the Commission, is unreasonable. In the absence of such a showing, the carrier does not offend against*

> *equity and conscience in standing on its possession and keeping what it got"* (pp. 317, 318). *Atlantic Coast Line Railroad Company* v. *State of Florida, supra.* (Emphasis supplied.)

This court's finding with regard to the futility of the search for certainty is particularly appropriate in the instant proceedings. The admitted lack of precision when coupled with the group rate-making technique clearly compounds the refund problem. Thus, the court below was correct in remanding to the Commission for its determination of an equitable basis for ordering refunds on a respondent-by-respondent, rate schedule-by-rate schedule basis.

The rates here under consideration reached the decisional stage by two dissimilar routes. By its *Order of December 23, 1960* the Commission consolidated all of the outstanding suspended rate increases under Section 4 (e) of the *Act* with all other rate schedules on file with the Commission within the delineated area. In each instance where increases had been suspended under Section 4(e) of the *Act,* the Commission had stated that such rate might be unjust, unreasonable or otherwise discriminatory. At the time, the sole standard for measuring the justness or reasonableness of any rate increase was by individual company cost-of-service. Thus, the only basis upon which a respondent could reliably determine to file a rate increase was to measure such increase, and the revenues derived therefrom in connection with overall company revenues compared with a company-wide cost-of-service.

The Commission changed that standard here when it proscribed cost-of-service presentations of any nature, individual or collective, and prescribed that the hearing to consolidate matters would consider economic considera-

tions and costs for the group of respondents. It was impossible, therefore, for any respondent, unless perfectly clairvoyant, to perceive that the standard to be utilized by the Commission in fixing just and reasonable rates, with respect to rate increases would be based upon a group's experience. Fair dealing and equity would forbid any Section 4(e) refund unless and until it is shown that some part of the increase is in excess of a just and reasonable rate individually determined. Since not all rate schedules were subject to suspension under Section 4(e) of the *Act*, refunds to be ordered, if any, are limited to less than all of the rate schedules in effect. However, all rate schedules are subject to Section 5(a) of the *Act* and to prospective reduction if so ordered. It is conceivable, therefore, that even if the Commission had matched its costing technique against industry revenues, which it admittedly failed to do, the available funds for refund might or might not have been sufficient to reduce the group's revenues from the area to the group's revenue requirements for the area as found by the Commission.

The problem is further complicated by the fact that numerous rates have been suspended involving increases to rates which are below the ceiling prices prescribed by the Commission's order. The refund pool is thus limited to those rates schedules which have rates in effect higher than the ceiling price fixed but limited to the difference between the ceiling price applicable to such rate schedule and the rate in effect subject to refund under Section 4(e) of the *Act*. This result necessarily follows that the impact of the Commission's orders will be primarily prospective in nature. It was for this reason that a number of producer respondents pointed out to the Commission that the group rate-making technique would provide fewer refunds to the

consumer than individual company approach. The result arises through no fault of those respondents whose costs are higher than the average of the group but rather because those companies whose costs are lower than the average receive, as a result of group rate making, receive a windfall rate of return which would be completely unconscionable in an individual situation.

VII.

THE NATURAL GAS ACT DOES NOT PERMIT THE AWARDING OF REPARATIONS

The Commission in its decision specifically reserved the question of whether in fact refunds should be ordered below the last firm rate (R. 1117d-1118d).[39] The *People of the State of California* in their brief at page 49 state in summary:

> ". . . Thus, in this sense, the area rate is the lawful rate for each individual producer in the area. It therefore follows that, as the Commission found, past rates collected subject to refund in excess of the lawful rate, i.e., the just and reasonable area rate, must be disallowed and refunded."

At page 57 the *People of the State of California* characterize the producer position as follows:

> "The producers also contended in the court below that the Commission may only order refunds of *rate increases* collected subject to refund under Section 4(e) of the Act. They vigorously denied that the Commis-

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[39] See also the Commission's Order of March 14, 1966, *In The Matter Of Gulf Oil Corporation,* which Order is set out in the Appendix.

sion is authorized to require refunds of the full amount of the *increased rate,* collected subject to refund, which exceeds the applicable area rate. The Commission has said that it will require refunds of all amounts collected subject to refund under Section 4(e) in excess of the applicable area rate (R. 672d, 695d-6d). We urge this Court to affirm the Commission's conclusion."

The *People of the State of California* argue ". . . *There is nothing in the statute which limits the amount refundable to the rate increase only.*" We reply to their position as respondents to their petition.

In the *Panhandle Eastern* case, 25 FPC 787 at 803,[40] the Commission's position on the point was stated as follows:

". . . It has apparently never been settled whether a refund can be ordered that reflects a rate decrease below settled rates previously in effect. *We do not believe we have to decide that question here* because it appears that the rates that will be determined in this proceeding will be higher than those determined in Docket No. G-1116, which are effective up until January 1, 1955 . . ." (Emphasis supplied.)

In the *Humble Oil and Refining Company* case, 25 FPC 1173, which involved an application to have that portion of a suspended rate below the area guideline removed from suspension and possible refund, the Commission's holding is limited to the increment between the last firm rate and the guideline. It correctly pointed out that the just and reasonable rate might in fact be below the Commission's own guideline level. This is shown by the Commission's statement:

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[40] This case and the Humble case, *infra,* have been cited by the Commission's Staff in subsequent area proceedings as authority for the Commission's power to order reparations.

> "... the issue is raised as to whether such *increased-rate* meets the requirement of Section 4, not whether the *increment-in-excess* of the area price meets such requirement."

We do not dispute that the entire rate is at issue prospectively under Section 5 of the *Act*. This is true notwithstanding the fact that Sections 4 and 5 of the *Act* are identical in their standard of just and reasonable. However, all authority is to the effect that refunds are limited to that portion of the funds constituting the incremental increase above the last firm rate which has been subject to the suspension order of the Commission under Section 4(e) of the *Act*. The reason for limiting the refund to the increment is quite obvious as any attempt to extend the refunds to more than the increment constitutes retroactive rate making and unlawful restitution. This Court has held that the Commission does have have the power to order restitution under its rate-making authority.[41]

In *Montana-Dakota Utilities Co.* v. *Northwestern Public Service Co.*, 341 U.S. 246, it was contended by petitioner that the *Federal Power Act's* requirement for just and reasonable rates gave petitioner a legal right to such rates, and further that petitioner might by court action find a just and reasonable rate at a level different than that accepted and filed with the Power Commission. After first pointing out that the legal rate was the filed rate, whether fixed by the Commission or merely accepted by the Commission, the court stated:

> "... The fact that the Congress withheld from the Commission power to grant reparations does not require courts to entertain proceedings they cannot

[41] The Commission power to order restitution appears to be limited to situations similar to *Callery* — see *United Gas Improvement Co.* v. *Callery Properties, Inc.*, 382 U.S. 223.

themselves decide in order indirectly to obtain Commission action which Congress did not allow to be taken directly . . . It is urged that this leaves petitioner without a remedy under the Power Act. We agree . . ." (p. 254).

This Court has never deviated from its finding that there is no residual right of restitution existing under the *Federal Power Act*,[42] which Act is essentially the same as Sections 4 and 5 of the *Natural Gas Act*. However, Mr. Justice Frankfurter's dissenting opinion specifically deals with the question of the funds which are available for refunding and he states:

". . . Wholesale consumers of electric energy were apparently considered, as a rule, adequately protected by the provisions of the Act authorizing the Commission to grant prospective relief and, in certain circumstances, to order refunding of *sums accumulated during the pendency of rate proceedings*. §§ 205(e), 206(a), 49 Stat. 852, 16 U.S.C. §§ 824d(e), 824e(a), 16 U.S.C.A. §§ 824d(e), 824e(a). Despite the unqualified statutory declaration that unreasonable rates are unlawful, we think it clear that Congress did not intend either court or Commission to have the power to award reparations on the ground that a properly filed rate or charge has in fact been unreasonably high or low . . ." p. 258). (Emphasis supplied.)

In *United Gas Pipe Line Company* v. *Willmut Gas and Oil Company*, 97 So. 2d 530, this court has held that the purpose of Section 4(e) of the *Act* is to preserve the status quo during the period required to determine the just and reasonable rate. In *United Gas Pipe Line Company* v. *Mobile Gas Service Corporation*, 350 U.S. 332 at 341, this Court stated:

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[42] 16 U.S.C.A. 824d(e), 824e(a).

> "All that Section 4(e) does, however, is to add . . . the further powers (1) to preserve the status quo pending review of the new rate by suspending its operation for a limited period, and (2) thereafter to make its order retroactive, by means of the refund procedure, to the date the change became effective. The scope and purpose of the Commission's review remain the same — to determine whether the rate fixed by the natural gas company is lawful."

In like manner the Court in *Sunray Mid-Continent Oil Company* v. *Federal Power Commission,* 364 U.S. 137 at 146, stated:

> ". . . If the hearing were not concluded by the end of the suspension period, the increased rate could be collected *ad interim;* but the Commission is empowered to require the company to collect the *increment* under bond and accounting, and refund it if it could not make out its case for the increase." (Emphasis added.)

It is quite clear that the antecedent of the word "it" which limits the amount of refund is that increment which is collected under bond and accounting.

We find statements to the same effect in the Decision by the U. S. Court of Appeals for the D. C. Circuit:

> "The Commission's power with respect to a filed increase is found in Section 4(e): to initiate a hearing as to the lawfulness of the changed rates, to suspend their effectiveness for a time, and to *order refunded that portion of the increase* which, after hearing, it determines to be unlawful" (p. 249). (Emphasis supplied.)[43]

A Decision of the Third Circuit in *Mississippi River Fuel*

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[43] *Willmut Gas & Oil Co.* v. *F.P.C.,* 294 F. 2d 245 (1961) *cert. den.* 368 U.S. 975; *reh. den.* 369 U.S. 813.

Corporation v. *Federal Power Commission,* 202 F. 2d 899 (1953), also appears to be in accordance. That Court states:

> "The Commission, upon completion of hearing and decision, is empowered, in the language of the statute, 'to order such natural-gas company to refund, with interest, the *portion of such increased rates* or charges by its decision found *not justified.*' This provision clearly demonstrates, if demonstration is needed, that Congress contemplated that there would be cases in which, after hearing, *some part of a requested increase* would be approved as justified even though *some other part* would be found inadequately supported and disallowed. It would be arbitrary and unfair to hold that the applicant includes any items of cost which in administrative judgment may turn out to be not allowable at peril of summary rejection of his entire proposal" (Italics added and by the Court).

In *Associated Oil & Gas Company* v. *Federal Power Commission,* 280 F. 2d 31 (5th Cir. 1960), at the end of the statutory suspension period the producer had not furnished the necessary bond nor placed the increased rate into effect. Subsequently the bond was furnished and the question arose as to whether the rate was effective although not collected in the absence of a bond. The decision of the court makes it quite clear that not only was the bond unnecessary to anything but the collection of the increased rate, but that the bond is limited by the court's interpretation of Section 4(e) to the increment which constitutes the increase over the prior rate.

The Commission's own rules and regulations also support the interpretation that the amount subject to refund is only the increment over the last firm rate. The Commission's

Regulations under the Natural Gas Act, Section 260.6, require that each year the producers file Form 301B. This report requires a listing rate schedule-by-rate schedule of the amounts collected subject to refund. The revenues subject to refund as reported by the producers in these filings have, in each instance, been limited to the amounts directly related to the increased increment. Further, with each order allowing a suspended rate go into effect, the Commission has prescribed quarterly reports by each producer of the amounts collected each quarter subject to refund. In each and every instance the amounts reported to and accepted by the Commission have been limited to the increment to the last firm rate.

Moreover, common sense dictates that any commercial entity regardless of regulation must carry on its everyday business. These entities must prepare annual reports, pay dividends if possible to their investors, pay income tax, both state and federal, pay royalties to their land owners promptly after the sale of oil or gas. It is quite apparent that if refund obligations are extended to cover the total amount collected under each and every rate schedule subject to suspension under Section 4(e), the entire operations of the industry would be jeopardized. Actual income of the companies would be an impossible determination; royalties could not be paid on any portion of the increased rate for fear that the voluntary payment made under mistake of law could not be recovered if the final rate fixed were below the last firm rate. Special accounts would have to be maintained to cover this contingent liability, but each entity would establish such account under the peril that the sufficiency of such account would cover the full amount of any potential refund.

CONCLUSION

WHEREFORE, for the reasons set forth above, Petitioner prays that the judgments of the Court of Appeals be reversed and the cases remanded to that Court with directions to vacate and set aside Commission Opinion Nos. 468 and 468-A and the orders thereof. Alternatively Petitioner prays that if this honorable Court finds that group rate making is lawful under the Constitution and the Natural Gas Act, that the opinion of the Court of Appeals be affirmed.

Respectfully submitted,

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Dated: October 9, 1967

APPENDIX "A"

THE CONSTITUTION OF THE UNITED STATES OF AMERICA

ARTICLE I

Section 1

Legislative powers vested in Congress. — All legislative Powers herein granted shall be vested in a Congress of the United States, which shall consist of a Senate and House of Representatives.

AMENDMENTS TO THE CONSTITUTION OF THE UNITED STATES

ARTICLE V

Trials for crimes; just compensation for private property taken for public use. — No person shall be * * * * * deprived of life, liberty, or property, without due process of law, nor shall private property be taken for public use, without just compensation.

THE NATURAL GAS ACT

SEC. 2. When used in this act, unless the context otherwise requires —

(1) "Person" includes an individual or a corporation.

(2) "Corporation" includes any corporation, joint-stock company, partnership, association, business trust, organized group of persons, whether incorporated or not, receiver or receivers, trustee or trustees of any of the foregoing, but shall not include municipalities as hereinafter defined.

— — — —

(6) "Natural-gas company" means a person engaged in the transportation of natural gas in interstate commerce, or the sale in interstate commerce of such gas for resale.

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RATES AND CHARGES; SCHEDULES; SUSPENSION OF NEW RATES

SEC. 4. (a) All rates and charges made, demanded, or received by any natural-gas company for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges, shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful.

(b) No natural-gas company shall, with respect to any transportation or sale of natural gas subject to the jurisdiction of the Commission, (1) make or grant any undue preference or advantage to any person or subject any person to any undue prejudice or disadvantage, or (2) maintain any unreasonable difference in rates, charges, service, facilities, or in any other respect, either as between localities or as between classes of service.

(c) Under such rules and regulations as the Commission may prescribe, every natural-gas company shall file with the Commission, within such time (not less than sixty days from the date this act takes effect) and in such form as the Commission may designate, and shall keep open in convenient form and place for public inspection, schedules showing all rates and charges for any transportation or sale subject to the jurisdiction of the Commission, and the classifications, practices, and regulations affecting such rates and charges, together with all contracts which in any manner affect or relate to such rates, charges, classifications, and services.

(d) Unless the Commission otherwise orders, no change shall be made by any natural-gas company in any such rate, charge, classification, or service, or in any rule, regula-

tions, or contract relating thereto, except after thirty days' notice to the Commission and to the public. Such notice shall be given by filing with the Commission and keeping open for public inspection new schedules stating plainly the change or changes to be made in the schedule or schedules then in force and the time when the change or changes will go into effect. The Commission, for good cause shown, may allow changes to take effect without requiring the thirty days' notice herein provided for by an order specifying the changes so to be made and the time when they shall take effect and the manner in which they shall be filed and published.

(e) Whenever any such new schedule is filed the Commission shall have authority, either upon complaint of any State, municipality, State commission, or gas distributing company[1a] or upon its own initiative without complaint, at once, and if it so orders, without answer or formal pleading by the natural-gas company, but upon reasonable notice, to enter upon a hearing concerning the lawfulness of such rate, charge, classification, or service; and, pending such hearing and the decision thereon, the Commission, upon filing with such schedules and delivering to the natural-gas company affected thereby a statement in writing of its reasons for such suspension, may suspend the operation of such schedule and defer the use of such rate, charge, classification, or service, but not for a longer period than five months beyond the time when it would otherwise go into effect;[1a] and after full hearings, either completed before or after the rate, charge, classification, or service goes into effect, the Commission may make such orders with reference thereto as would be proper in a proceeding initiated after it had become effective. If the proceeding has

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[1a] Subsection 4 (e) was amended May 21, 1962 by Public Law 87-454, 87th Congress, 2d Session [S. 1595], 76 Stat. 72.

not been concluded and an order made at the expiration of the suspension period, on motion of the natural-gas company making the filing, the proposed change of rate, charge, classification, or service shall go into effect. Where increased rates or charges are thus made effective, the Commission may, by order, require the natural-gas company to furnish a bond, to be approved by the Commission, to refund any amounts ordered by the Commission, to keep accurate accounts in detail of all amounts received by reason of such increase, specifying by whom and in whose behalf such amounts were paid, and, upon completion of the hearing and decision, to order such natural-gas company to refund, with interest, the portion of such increased rates or charges by its decision found not justified. At any hearing involving a rate or charge sought to be increased, the burden of proof to show that the increased rate or charge is just and reasonable shall be upon the natural-gas company, and the Commission shall give to the hearing and decision of such questions preference over other questions pending before it and decide the same as speedily as possible. [52 Stat. 822 (1938); 76 Stat. 72 (1962); 15 U.S.C. § 717c]

FIXING RATE AND CHARGES; DETERMINATION OF COST OF PRODUCTION OR TRANSPORTATION

SEC. 5. (a) Whenever the Commission, after a hearing had upon its own motion or upon complaint of any State, municipality, State commission, or gas distributing company, shall find that any rate, charge, or classification demanded, observed, charged, or collected by any natural-gas company in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Com-

mission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order: *Provided, however,* That the Commission shall have no power to order any increase in any rate contained in the currently effective schedule of such natural-gas company on file with the Commission, unless such increase is in accordance with a new schedule filed by such natural-gas company; but the Commission may order a decrease where existing rates are unjust, unduly discriminatory, preferential, otherwise unlawful, or are not the lowest reasonable rates.

(b) The Commission upon its own motion, or upon the request of any State commission, whenever it can do so without prejudice to the efficient and proper conduct of its affairs, may investigate and determine the cost of the production or transportation of natural gas by a natural-gas company in cases where the Commission has no authority to establish a rate governing the transportation or sale of such natural gas. [52 Stat. 823 (1938); 15 U.S.C. § 717d]

EXTENSION OF FACILITIES; ABANDONMENT OF SERVICE

SEC. 7. (a) Whenever the Commission, after notice and opportunity for hearing, finds such action necessary or desirable in the public interest, it may by order direct a natural-gas company to extend or improve its transportation facilities, to establish physical connection of its transportation facilities with the facilities of, and sell natural gas to, any person or municipality engaged or legally authorized to engage in the local distribution of natural or artificial gas to the public, and for such purpose to extend its transportation facilities to communities immediately

adjacent to such facilities or to territory served by such natural-gas company, if the Commission finds that no undue burden will be placed upon such natural-gas company thereby: *Provided,* That the Commission shall have no authority to compel the enlargement of transportation facilities for such purposes, or to compel such natural-gas company to establish physical connection or sell natural gas when to do so would impair its ability to render adequate service to its customers. [52 Stat. 824 (1938); 15 U.S.C. § 717f (a)]

(b) No natural-gas company shall abandon all or any portion of its facilities subject to the jurisdiction of the Commission, or any service rendered by means of such facilities, without the permission and approval of the Commission first had and obtained, after due hearing, and a finding by the Commission that the available supply of natural gas is depleted to the extent that the continuance of service is unwarranted, or that the present or future public convenience or necessity permit such abandonment. [52 Stat. 824 (1938); 15 U.S.C. § 717f(b)]

(c)[2] No natural-gas company or person which will be a natural-gas company upon completion of any proposed construction or extension shall engage in the transportation or sale of natural gas, subject to the jurisdiction of the Commission, or undertake the construction or extension of any facilities therefor, or acquire or operate any such facilities or extensions thereof, unless there is in force with respect to such natural-gas company a certificate of public convenience and necessity issued by the Commission authorizing such acts or operations: *Provided, however,* That if any such natural-gas company or predecessor in interest was bonafide engaged in transportation or

[2] Subsection 7 (c) amended; (d), (e), (f) and (g) added February 7, 1942 by Public Law No. 444, 77th Congress, Chapter 49, 2d Session [H. R. 5249], 56 Stat. 83, 84.

sale of natural gas, subject to the jurisdiction of the Commission, on the effective date of this amendatory Act, over the route or routes or within the area for which application is made and has so operated since that time, the Commission shall issue such certificate without requiring further proof that public convenience and necessity will be served by such operation, and without further proceedings, if application for such certificate is made to the Commission within ninety days after the effective date of this amendatory Act. Pending the determination of any such application, the continuance of such operation shall be lawful.

In all other cases the Commission shall set the matter for hearing and — — — —

(d)[4] (omitted)

(e)[5] Except in the cases governed by the provisos contained in subsection (c) of this section, a certificate shall be issued to any qualified applicant therefor, authorizing the whole or any part of the operation, sale, service, construction, extension, or acquisition covered by the application, if it is found that the applicant is able and willing properly to do the acts and to perform the service proposed and to conform to the provisions of the Act and the requirements, rules, and regulations of the Commission thereunder, and that the proposed service, sale, operation, construction, extension, or acquisition, to the extent authorized by the certificate, is or will be required by the present or future public convenience and necessity; otherwise such application shall be denied. The Commission shall have the power to attach to the issuance of the certificate and to the exercise of the

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[4, 5, 6] See footnote 2, p. 7.

rights granted thereunder such reasonable terms and conditions as the public convenience and necessity may require. [56 Stat. 84 (1942); 15 U.S.C. § 717f (e)]

— — — —

ADMINISTRATION POWERS OF COMMISSION; RULES, REGULATIONS, AND ORDERS

SEC. 16. The Commission shall have power to perform any and all acts, and to prescribe, issue, make, amend, and rescind such orders, rules, and regulations as it may find necessary or appropriate to carry out the provisions of this act. Among other things, such rules and regulations may define accounting, technical, and trade terms used in this act; and may prescribe the form or forms of all statements, declarations, applications, and reports to be filed with the Commission, the information which they shall contain, and the time within which they shall be filed. Unless a different date is specified therein, rules and regulations of the Commission shall be effective thirty days after publication in the manner which the Commission shall prescribe. Orders of the Commission shall be effective on the date and in the manner which the Commission shall prescribe. For the purposes of its rules and regulations, the Commission may classify persons and matters within its jurisdiction and prescribe different requirements for different classes of persons or matters. All rules and regulations of the Commission shall be filed with its secretary and shall be kept open in convenient form for public inspection and examination during reasonable business hours. [52 Stat. 830 (1938); 15 U.S.C. § 717o]

FEDERAL POWER ACT

§ 824d. Rates and charges; schedules; suspension of new rates

(a) All rates and charges made, demanded, or received by any public utility for or in connection with the transmission or sale of electric energy subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful.

(b) No public utility shall, with respect to any transmission or sale subject to the jurisdiction of the Commission, (1) make or grant any undue preference or advantage to any person or subject any person to any undue prejudice or disadvantage, or (2) maintain any unreasonable difference in rates, charges, service, facilities, or in any other respect, either as between localities or as between classes of service.

(c) Under such rules and regulations as the Commission may prescribe, every public utility shall file with the Commission, within such time and in such form as the Commission may designate, and shall keep open in convenient form and place for public inspection schedules showing all rates and charges for any transmission or sale subject to the jurisdiction of the Commission, and the classifications, practices, and regulations affecting such rates and charges, together with all contracts which in any manner affect or relate to such rates, charges, classifications, and services.

(d) Unless the Commission otherwise orders, no change shall be made by any public utility in any such rate, charge, classification, or service, or in any rule, regulation, or contract relating thereto, except after thirty days' notice to

the Commission and to the public. Such notice shall be given by filing with the Commission and keeping open for public inspection new schedules stating plainly the change or changes to be made in the schedule or schedules then in force and the time when the change or changes will go into effect. The Commission, for good cause shown, may allow changes to take effect without requiring the thirty days' notice herein provided for by an order specifying the changes so to be made and the time when they shall take effect and the manner in which they shall be filed and published.

16 § 824d

(e) Whenever any such new schedule is filed the Commission shall have authority, either upon complaint or upon its own initiative without complaint, at once, and, if it so orders, without answer or formal pleading by the public utility, but upon reasonable notice, to enter upon a hearing concerning the lawfulness of such rate, charge, classification, or service; and, pending such hearing and the decision thereon, the Commission, upon filing with such schedules and delivering to the public utility affected thereby a statement in writing of its reasons for such suspension, may suspend the operation of such schedule and defer the use of such rate, charge, classification, or service, but not for a longer period than five months beyond the time when it would otherwise go into effect, and after full hearings, either completed before or after the rate, charge, classification, or service goes into effect, the Commission may make such orders with reference thereto as would be proper in a proceeding initiated after it had become effective. If the proceeding has not been concluded and an order made at the expiration of such five months, the proposed change of rate, charge, classification, or service shall go into effect at the end of such period, but in case of a proposed increased rate

or charge, the Commission may by order require the interested public utility or public utilities to keep accurate account in detail of all amounts received by reason of such increase, specifying by whom and in whose behalf such amounts are paid, and upon completion of the hearing and decision may by further order require such public utility or public utilities to refund, with interest, to the persons in whose behalf such amounts were paid, such portion of such increased rates or charges as by its decision shall be found not justified. At any hearing involving a rate or charge sought to be increased, the burden of proof to show that the increased rate or charge is just and reasonable shall be upon the public utility, and the Commission shall give to the hearing and decision of such questions preference over other questions pending before it and decide the same as speedily as possible. June 10, 1920, c. 285, § 205, as added Aug. 26, 1935, c. 687, Title II, § 213, 49 Stat. 851.

§ 824e. Power of Commission to fix rates and charges; determination of cost of production or transmission

(a) Whenever the Commission, after a hearing had upon its own motion or upon complaint, shall find that any rate, charge, or classification, demanded, observed, charged, or collected by any public utility for any transmission or sale subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order.

(b) The Commission upon its own motion, or upon the request of any State commission whenever it can do so without prejudice to the efficient and proper conduct of its

affairs, may investigate and determine the cost of the production or transmission of electric energy by means of facilities under the jurisdiction of the Commission in cases where the Commission has no authority to establish a rate governing the sale of such energy. June 10, 1920, c. 285, § 206, as added Aug. 26, 1935, c. 687, Title II, § 213, 49 Stat. 852.

TRANSPORTATION ACT OF 1920

§ 15, par. (6). Commission to establish just divisions of joint rates, fares, or charges; adjustments. Whenever, after full hearing upon complaint or upon its own initiative, the Commission is of opinion that the divisions of joint rates, fares, or charges, applicable to the transportation of passengers or property, are or will be unjust, unreasonable, inequitable, or unduly preferential or prejudicial as between the carriers parties thereto (whether agreed upon by such carriers, or any of them, or otherwise established), the Commission shall by order prescribe the just, reasonable, and equitable divisions thereof to be received by the several carriers, and in cases where the joint rate, fare, or charge was established pursuant to a finding or order of the Commission and the divisions thereof are found by it to have been unjust, unreasonable, or inequitable, or unduly preferential or prejudicial, the Commission may also be order determine what (for the period subsequent to the filing of the complaint or petition or the making of the order of investigation) would have been the just, reasonable, and equitable divisions thereof to be received by the several carriers, and require adjustment to be made in accordance therewith. In so prescribing and determining the divisions of joint rates, fares, and charges, the Commission shall give due consideration, among other things, to the efficiency with which the carriers concerned are operated, the amount of revenue required to pay their respective operating expenses,

taxes, and a fair return on their railway property held for and used in the service of transportation, and the importance to the public of the transportation services of such carriers; and also whether any particular participating carrier is an originating, intermediate, or delivering line, and any other fact or circumstance which would ordinarily, without regard to the mileage haul, entitle one carrier to a greater or less proportion than another carrier of the joint rate, fare, or charge. Feb. 4, 1887, c. 104, Pt. I, § 15, 24 Stat. 384; Feb. 28, 1920, c. 91, § 418, 41 Stat. 484.

49 U.S.C. 1482 (C.A.B.)

POWER TO PRESCRIBE RATES AND PRACTICES OF AIR CARRIERS

(d) Whenever, after notice and hearing, upon complaint, or upon its own initiative, the Board shall be of the opinion that any individual or joint rate, fare, or charge demanded, charged, collected or received by any air carrier for interstate or overseas air transportation, or any classification, rule, regulation, or practice affecting such rate, fare, or charge, or the value of the service thereunder, is or will be unjust or unreasonable, or unjustly discriminatory, or unduly preferential, or unduly prejudicial, the Board shall determine and prescribe the lawful rate, fare, or charge (or the maximum or minimum, or the maximum and minimum thereof) thereafter to be demanded, charged, collected, or received, or the lawful classification, rule, regulation, or practice thereafter to be made effective: *Provided*, That as to rates, fares, and charges for overseas air transportation, the Board shall determine and prescribe only a just and reasonable maximum or minimum, or maximum and minimum rate, fare, or charge.

RULE OF RATE MAKING

(e) In exercising and performing its powers and duties with respect to the determination of rates for the carriage

NCR

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CARD 49

f persons or property, the Board shall take into considera-on, among other factors —

(1) The effect of such rates upon the movement of traffic;

(2) The need in the public interest of adequate and efficient transportation of persons and property by air carriers at the lowest cost consistent with the furnishing of such service;

(3) Such standards respecting the character and quality of service to be rendered by air carriers as may be prescribed by or pursuant to law;

(4) The inherent advantages of transportation by aircraft; and

(5) The need of each air carrier for revenue sufficient to enable such air carrier, under honest, economical, and efficient management, to provide adequate and efficient air carrier service.

APPENDIX "B"

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Before Commissioners: Lee C. White, Chairman; L. J. O'Connor, Jr., Charles R. Ross, David S. Black, and Carl E. Bagge.

GULF OIL CORPORATION	}	Docket Nos. RI63-265, RI64-83, and RI64-176

ORDER DENYING PETITIONS TO WITHDRAW INCREASED RATE FILINGS

(Issued March 14, 1966)

On January 6, 1966, Gulf Oil Corporation (Gulf) filed petitions in the above-entitled proceedings seeking to withdraw its increased rate filings[1] in excess of the 16 cents per Mcf permanently certificated rates under its FPC Gas Rate Schedule Nos. 138, 193, 194, 197, 213 and 215 for its jurisdictional sales of natural gas in the Permian Basin Area of Texas and New Mexico. All of the sales involved are to Transwestern Pipeline Company, except Gulf's sale under its FPC Gas Rate Schedule No. 138 to West Texas Gathering Company.

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[1] Gulf proposes to withdraw its increase in rates from 16 cents to 17 cents per Mcf under its Rate Schedule No. 138, which is involved in Docket No. RI63-265, and under its Rate Schedule Nos. 193, 194 and 197, which are involved in Docket Nos. RI64-173; and also to withdraw its increase in rates from 16 cents to 16.077 cents under its Rate Schedule Nos. 213 and 215 which are involved in Docket No. RI64-83. The former increased rate group represent 1.0 cent per Mcf periodic increases, and the latter reflect reimbursement for the 0.55 cents per Mcf New Mexico Emergency School Tax increase of April 1, 1963. All of the increased rates involved are being collected subject to refund in the respective docketed proceedings.

In its petitions, Gulf proposes, upon being permitted to withdraw said filings, to refund with interest all of the amount of increase collected thereunder; and requests that the aforementioned docketed proceedings be served from the "Show Cause" proceedings in Docket Nos. AR61-1, *et al.*, instituted by order issued therein on August 5, 1965, and that Docket Nos. RI63-265, RI64-83 and RI64-176 be terminated insofar as they relate to the withdrawn filings. Gulf states that the intent and purpose of the petitions is to place Gulf and its purchasers in the same position they would have been in had the increased rates involved never have been filed and placed into effect.

An answer in opposition to Gulf's petition to withdraw its increased rate filing in Docket No. RI64-176 was filed by telegram on February 6, 1966 by The People of The State of California and the Public Utilities Commission of The State of California (California Commission). In its answer, the California Commission states:

> "* * * Petitioner Gulf seeks to re-establish an unjust and unreasonable rate. It is obvious that by this petition, as well as by its similar petition in Docket No. RI64-83, Gulf is attempting to avoid the effect of Opinions 468 and 468-A, and thereby retain the benefits of higher rates than those prescribed for all dockets in the Permian Basin area rate proceeding, Docket No. AR61-1. Granting these petitions would thwar(t) the purpose of area rate making. * * *"

The subject Section 4 (e) proceedings under the National Gas Act were not consolidated in the Permian Basin Area Proceeding, Docket Nos. AR61-1, *et al.*, but were therefore included in the aforementioned "Show Cause" proceeding to afford Gulf, and the other respondents, the hearing to which they are entitled for the purpose among other things, of determining the refund obligations under their formerly non-consolidated Section 4 (e) proceedings. The Cali-

fornia Commission's objection appears to be directed to the question of whether or not the Commission has authority to require refunds in a Section 4 (e) proceeding below the last unsuspended rate. It is apparently the California Commission's position that during the refund period, Gulf should make refunds to a rate level of 14.5 cents per Mcf, or other quality adjusted rate, for the Texas sales and 13.5 cents per Mcf, plus applicable state and local production taxes, for the New Mexico sales, even though Gulf's last clean rate for these sales is 16 cents per Mcf.

While certain parties briefed this issue in the Permian Basin Area rate proceeding, it was not decided in Opinion No. 468-A, (mimeo p. 10) since it was not clear that the issue was raised as a result of that order, and we indicated that a decision thereon would be reached " * * * when and if it is established that any refunds below the last clean rate are required". We do not deem it appropriate to rule on this question in the context of petitions to withdraw increased rate filings and we shall deny the petitions as filed. However, if Gulf so desires, we shall permit withdrawal of the increased rate filing and refund of the amount of the increase but will not terminate the proceedings so that the question of further refunds may be determined upon consideration of the problem in the Permian Basin area generally.

The Commission orders:

For the foregoing reasons, Gulf's petitions filed January 6, 1966 in Docket Nos. RI63-265, RI64-83 and RI64-176 are denied.

By the Commission.

[SEAL]

JOSEPH H. GUTRIDE,
Secretary.

PETITIONER'S BRIEF

RESPONDENT'S BRIEF

"Permian Basin Area Rate Cases"
Nos. 90, 95, 98, 99, 100, 101, 102, 105, 117, 181

OCT 9 1967
JOHN F. DAVIS, CLER

IN THE

Supreme Court of the United States

OCTOBER TERM, 1967

No. 99

SUN OIL COMPANY,

v.

FEDERAL POWER COMMISSION, *et al.*

No. 117

FEDERAL POWER COMMISSION,

v.

SKELLY OIL COMPANY, *et al.*
SUN OIL COMPANY

On Writs of Certiorari to the United States Court of Appeals for the Tenth Circuit

BRIEF OF SUN OIL COMPANY,

PETITIONER IN NO. 99
RESPONDENT IN NOS. 100, 102, 117, 181

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October 9, 1967

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1967

"Permian Basin Area Rate Cases"
Nos. 90, 95, 98, 99, 100, 101, 102, 105, 117, 181

No. 99

SUN OIL COMPANY,

v.

FEDERAL POWER COMMISSION, *et al.*

No. 117

FEDERAL POWER COMMISSION,

v.

SKELLY OIL COMPANY, *et al.*
SUN OIL COMPANY

On Writs of Certiorari to the United States Court of Appeals for the Tenth Circuit

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BRIEF OF SUN OIL COMPANY,

PETITIONER IN NO. 99
RESPONDENT IN NOS. 100, 102, 117, 181

OPINIONS BELOW

The opinion of the Court of Appeals for the Tenth Circuit is reported at 375 F. 2d 6 (A. XII/15-61),[1]

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[1] References to the joint appendix will be designated "A." Roman numerals refer to the volume and arabic numbers to the page. The supplemental appendix volume will be designated "Supp." References to portions of the record not printed will be designated "R."

and the court's opinion on rehearing is reported at 375 F. 2d 35 (A. XII/87-89). Opinion No. 468 of the Respondent, Federal Power Commission (hereinafter termed "Commission") (A. X/516d-XI/826d), is reported at 34 FPC 159. Opinion No. 468-A (A. XI/1105d) is reported at 34 FPC 1068. The decision of the Commission's Hearing Examiner is reported at 34 FPC 306 (A. IX/97d).

JURISDICTION

The judgments of the Court of Appeals for the Tenth Circuit were entered on January 20, 1967 with respect to petitioner Sun Oil Company (Sun) (A. XII/71-72) and others. The court's order on rehearing was entered on April 19, 1967 (A. XII/87-89). Jurisdiction of this Court is conferred by Section 19(b) of the Natural Gas Act, 15 U.S.C. § 717r(b), and 28 U.S.C. § 1254. Certiorari was granted by this Court's order issued June 13, 1967 (388 U.S. 906) (A. XII/89-90) in Nos. 1274, 1287, 1291, 1292, 1293, 1294, 1295, 1302, 1342 and 1412 of the October 1966 Term.[2] The cases were designated the "Permian Basin Area Rate Cases" and were consolidated for argument.[3]

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[2] Nos. 90, 95, 98, 99, 100, 101, 102, 105, 117, 181, respectively, of the October 1967 Term. Petitions for certiorari are pending with respect to the same decision of the court of appeals in Nos. 261, 262, 266, 292.

[3] This Court's June 13, 1967 order also aligned the parties for briefing to provide that parties supporting the Commission's order should first file briefs, followed by those attacking the Commission's order. Sun Oil Company is petitioner in No. 99 and Respondent in Nos. 100, 102, 117 and 181. In this brief Sun attacks the Commission's order.

QUESTIONS PRESENTED

By its Opinion No. 468 the Commission purported to determine just and reasonable rates for the first time on a group basis. The rates fixed by the Commission were ceiling prices that purportedly were predicated on averages of costs and other claimed costs derived from a number of sources. The Court of Appeals for the Tenth Circuit affirmed the group method of fixing rates and the averages employed by the Commission, but set aside the opinion because there was no finding that group revenues would equate to group costs and no adequate "savings clause" provision whereby individuals in the group could, upon proper showing, be exempted from the group rates. The questions presented by this brief are:

(1) Whether the Commission can fix just and reasonable rates under Sections 4 and 5 of the Natural Gas Act by a group method which wholly ignores the inability of the group or of individual producers in the group to recover their operating expenses and capital charges at the rates fixed.

(2) Whether the Commission erred in the first instance by failing even to consider the system of reconciling individual costs with group costs long practiced by the Interstate Commerce Commission and approved by this Court in fixing group rates and divisions.

(3) Whether the Commission, notwithstanding its failure to consider the Interstate Commerce Commission's method of reconciling individual costs and group costs could nevertheless have met the criteria of that method by (a) using costs that are typical and representative of the com-

panies whose rates are being fixed, and (b) providing individuals the opportunity to make an effective savings clause presentation.

(4) Whether a savings clause presentation is proper that precludes showings that (a) the individual's property would be confiscated by the rates fixed; (b) the individual's costs were atypical of the group; (c) the individual should be allowed its dry hole costs; (d) rates which may have been just and reasonable when fixed are no longer just and reasonable by reason of changed conditions.

(5) Whether a procedure providing for a savings clause presentation is proper that precludes the presentation during the course of the hearings fixing rates and does not provide for a hearing on the savings clause presentation as a matter of right or for a stay of the rates fixed during the indefinite period prior to decision on the savings clause presentation.

(6) Whether the costs derived by the Commission in its old gas study are appropriate for fixing the old gas prices in view of the (a) lack of representativeness of the basic data, (b) the failure to afford the opportunity to cross examine and rebut the basic data and the costs attributed to individual producers, and (c) the lack of representativeness of the weighted averages that were determined.

(7) Whether the costs derived by the Commission in its new gas study are appropriate for fixing the new gas prices in view of (a) the use of data from the old gas study which is subject to the deficiencies set forth in (6) above; (b) the use in

a purportedly national study of costs, of data from Permian Basin producers who produced but one-third of the gas produced nationally and drilled but 24% of the wells drilled nationally; (c) the absence of standards as evidenced by the rejection of data as unrepresentative, but the use of the same data otherwise; (d) the use of Census data which has been declared by the Secretary of Commerce to be not acceptable for financial purposes.

STATUTES INVOLVED

The statutory provisions involved are Sections 4 and 5(a) of the Natural Gas Act [15 U.S.C. §§ 717(c) and 717(d)(a)] [4] and Section 7(c) of the Administrative Procedure Act [15 U.S.C. § 1006(c)]. They are printed in the appendix hereto.

STATEMENT

I. HISTORY OF PRODUCER RATE REGULATION

These proceedings are another chapter in the Federal Power Commission's efforts to fix just and reasonable rates for the sale of natural gas for resale in interstate commerce by independent producers of such gas. This rate regulation is undertaken pursuant to the Natural Gas Act [15 U.S.C. §§ 717-717w] and in particular Section 4(a) thereof which provides that "All rates and charges made, demanded or received by any natural gas company . . . shall be just and reasonable . . . ."

The Commission's jurisdiction over independent producers was first determined by this Court in the *First Phillips* case, *Phillips Petroleum Company* v. *Wisconsin*, 347 U.S. 672 (1954). Thereafter, the Commission

[4] Sometimes referred to as "the Act".

initiated its first producer rate proceedings. In the absence of contrary advice by the Commission on the method by which it would determine just and reasonable rates, the producers undertook to support their contract prices on the basis of comparable negotiated prices. This was in accordance with the Commission's action in a pipeline rate case involving the allowance for gas produced by the pipe line, *Panhandle Eastern Pipe Line Company,* 13 FPC 53, 59-77 (1954). The Commission, however, dismissed these producer presentations and the producers appealed. In a series of decisions by the Fifth Circuit,[5] the Commission's orders dismissing the producer presentations were reversed with directions that the producers be afforded the opportunity to support their rates in accordance with the determination of the Court of Appeals for the District of Columbia Circuit in *City of Detroit* v. *Federal Power Commission,* 230 F. 2d 810 (1955), *cert. den.,* 352 U.S. 829 (1956). This case, which had in the interim reversed the Commission's aforementioned *Panhandle* decision, held that a cost showing was necessary to the "just and reasonable" standard of the Act —at least as a point of departure (230 F. 2d at 818).

The Commission next approached the producer price problem on remand by consolidating in company-wide rate cases numerous rate increase applications filed pursuant to Section 4(e) of the Act. Also consolidated in these individual company cases was an over-all investigation of the particular producer's rates instituted pursuant to Section 5(a) of the Act. These cases were heard largely on the basis of company-wide costs of

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[5] e.g., *Bel Oil Corporation* v. *Federal Power Commission,* 255 F. 2d 548 (5th Cir. 1958); *Sun Oil Company* v. *Federal Power Commission,* 255 F. 2d 557, *cert. den.,* 358 U.S. 804.

service. Only one major case of this type was carried through and disposed of by a Commission Opinion, *Phillips Petroleum Company,* 24 FPC 537 (1960).

In the *Phillips* rate case, Opinion No. 338, the Commission found that a cost-of-service for Phillips could be found on a utility-type rate base method (24 FPC at 547) and that Phillips' prices, as in the case of virtually all other cases it had considered on an individual cost basis, were fully justified thereby (24 FPC at 546). Nevertheless, the Commission found that the rate base method of regulation was unworkable and would produce fallacious results (24 FPC at 543). The Commission's finding that the rate base method was unworkable was principally based on the extreme problems involved in making allocations and the fact that in practice allocations are simply "* * * a means of supporting a result already arrived at, rather than a means of arriving at a result which was previously unknown" (24 FPC at 542, 543-544). In addition, the Commission noted great difficulty in finding a unit cost of gas because of the uncertainty of estimating the extent of gas reserves, because of tax problems due to depletion and intangible well-drilling costs, because of problems in finding rates for co-owners and producers selling under percentage type contracts, and because of the effect on the interests of royalty owners (24 FPC at 544). The Commission also emphasized the administrative burden involved in producer regulation in view of the number of cases pending (24 FPC at 546). Finally, the Commission candidly suggested that part of its disenchantment with the company-by-company rate base method was that it was quite clear that the approach justified higher prices since in almost all instances it had found that gas was "substantially underpriced" (24 FPC at 546-547).

The Commission then indicated that it was establishing a new approach to producer rate regulation in which it would set prices in all producing areas. The method of regulation proposed was not explained, but it was stated that cost data and economic information would be used. Further, the Commission stated that "a representative sampling of the industry in any one area must be accepted as part of the basis for fixing rates for all producers in the area" (24 FPC at 547).

The first step in fixing area rates was the concurrent promulgation of a "Policy Statement" setting forth rate guidance levels for various producing areas of the country, *Statement of General Policy No. 61-1,* 24 FPC 818 (1960). This Policy Statement divided the nation into a number of geographical areas which the Commission stated were convenient and well known, although "not necessarily in complete accord with geographical and economic factors which may be relevant to the establishment of pricing areas" (24 FPC at 819). For each area two prices were prescribed, first a higher price representing the level above which the Commission would not issue certificates of public convenience and necessity for new sales without justification of the price, and second, a lower price representing the level at or below which the Commission would permit rate increases for existing sales to go into effect without suspension or justification in a rate proceeding pursuant to Section 4 of the Act. These prices were stated to be based on "all of the relevant facts available to us * * * [including] cost information from all decided and pending cases, existing and historical price structures, volumes of production, trends in production, price trends in the various areas over a number of years, trends in exploration and

development, trends in demands, and the available markets for the gas" (24 FPC at 819). The Policy Statement indicated, however, that there would be further proceedings leading to "a determination of a proper revision, if any, in an area price or in the geographical area itself" (24 FPC at 820). The orders here under review are the result of such further proceedings.

Both the Commission's *Phillips* determination and its Policy Statement were appealed. As to the latter the appeal was dismissed for want of aggrievement, *Wisconsin* v. *Federal Power Commission,* 292 F. 2d 753 (D.C. Cir. 1961). The *Phillips* determination was affirmed, first by the Court of Appeals for the District of Columbia Circuit, *Wisconsin* v. *Federal Power Commission,* 303 F. 2d 380 (D.C. Cir. 1961), and later by this Court in *Wisconsin* v. *Federal Power Commission,* 373 U.S. 294 (1963), *Second Phillips.*

During the course of the *Second Phillips* appeal the appellants argued that the Commission erred in not making a specific finding of what were "just and reasonable" rates. In particular the People and the Public Utilities Commission of the State of California urged that the Commission's reliance on the area rate proceedings then in process was insufficient reason for not making the finding because there could be no departure from the individual cost of service method of regulation. Other appellants took less positive positions on the validity of the area approach, contending that in any event the Commission should pursue to a termination the *Phillips* proceedings already commenced.

In a 5 to 4 decision this Court upheld the Commission, finding that "we have no indication that the area method will fall short of statutory or constitutional

standards" (373 U.S. at 309), although it admitted that "the lawfulness of the area pricing method * * * [is not in itself] before the Court for review" (373 U.S. at 308). The dissent expressed serious doubts of "both the wisdom and the legality of this approach to price determination * * *" (373 U.S. at 327), and noted that it was "* * * both premature and dangerous to pass any judgment at this stage of the proceedings" (373 U.S. at 326).

II. THE CURRENT PROCEEDINGS

A. Commission Orders Governing the Course of the Proceedings

The proceedings here under review were instituted by a Commission order issued December 23, 1960 in Docket No. AR61-1 (24 FPC at 1121) (A. IX/1d). In this order the Commission noted that the schedule of prices in its Policy Statement were not intended to constitute a determination of just and reasonable rates. It then provided for an area rate hearing to determine "a just and reasonable area producer rate, or rates, * * *" within the Permian Basin of New Mexico and Texas and named a number of respondents to the proceedings including Sun. The order further consolidated a number of pending dockets involving producer applications for certificates of public convenience and necessity and rate increases and provided for a prehearing conference.

In its order of December 23, 1960, the Commission also reiterated its prior finding in the Policy Statement that the geographical areas might not ultimately be found appropriate for the establishment of proper pricing areas. Nevertheless, the order held that "no useful purpose would be served * * * by entertaining

issues or considering contentions that the areas we have delineated in our Statement might be inappropriate for rate making purposes" (A. IX/3d).

Subsequent to the issuance of the December 23, 1960 order instituting the area rate proceedings, a number of motions were filed seeking guidance on the nature of proof the Commission would consider in the area proceedings. In addition, on May 26, 1961, the Commission's Chief Presiding Examiner, following prehearing conferences on March 7 and 8 and April 27, 1961, submitted a comprehensive report pointing out "the uncertainty as to what evidence would be desired" and the inadequacy of preparation for the conference (R. 270138). The Commission then issued a series of orders pertaining to the proof it would require. Although these orders revealed an ever-changing concept of what evidence would be required and who should file it, they were consistent in one aspect—an unwavering refusal to permit any evidence that would show the effect of the rates proposed on the individuals regulated.

On February 3, 1961 (25 FPC 249) the Commission denied as premature a motion by Slade, Inc. requesting that the December 23, 1960 order be modified to assure that individual producers were permitted the opportunity to show the reasonableness of the rates fixed as to themselves and requesting an opportunity to argue the legal issues (A. IX/25d). Next, in response to a motion by Texaco Seaboard, Inc., the Commission on April 5, 1961 (25 FPC 614) ruled that it would not permit cost of service studies on either an individual or group basis, although it would permit "cost data" as opposed to a "cost-of-service." Commissioner Kline dissented to the extent that he would have permitted composite costs of service (A. IX/29d).

Thereafter, by order of August 2, 1961 (26 FPC 247) the Commission fixed a date for the commencement of hearings and provided for the submittal of responses to a questionnaire appended to the order. Seven categories of data was sought: (1) existing and historical price structures; (2) pricing trends; (3) history and trend in gas production; (4) history of and trends in exploration and development; (5) available markets for gas; (6) trends in demand for gas; and (7) certain cost data. The first six of these items were termed "data of an economic nature" and were to be obtained in part by compilations by the Commission Staff from material in the Commission files and in part from answers to a questionnaire designated Appendix A. The seventh item, "certain cost data" was to be obtained through an appended questionnaire designated as Appendix B (A. IX/39d-41d). By its August 2 order and the subsequent order of September 8, 1961 (A. Supp/13s), the Commission provided that when the hearings convened presentations should initially be as to the economic aspects of the case, and at the end of the producers' direct case on the economic issues the Examiner should fix a procedure for filing written motions to strike and answers thereto. Thus, the Commission provided a sharp dividing line between the economic and cost phases of the case.

Because of uncertainty whether a sample of costs would be representative, the August 2 order also found it to be desirable that cost data be included for operations of all producers in the area. The order thus provided that Appendix A should be completed by all respondents; that Appendix B should be completed by all respondents with company-wide jurisdictional sales

of 2,000,000 Mcf during 1960, and that another order would be issued requiring smaller producers to file cost data (A. IX/41d).

The August 2, 1961 order also ruled that a further motion of Slade, Inc. seeking the opportunity to present evidence to show the reasonableness of the rate or rates determined as to itself was still premature. Nevertheless, the Commission left little doubt as to what its ruling would be. Thus the order states that the Commission's determination would be "in the nature of setting a price for the gas itself from any source questioned and not necessarily a price applicable solely to the party proposing some other price." Furthermore, the Commission held that data would be developed on a group basis and presentations demonstrating the reasonableness of a particular rate or rates of individual producers would vitiate the purpose of the hearing (A. IX/42d).

Subsequent orders of the Commission issued September 18 and September 25, 1961 produced further changes in the nature of evidence to be required or permitted. Revisions were made in Appendix A (A. IX/47d) and Appendix B (R. 272678), and it was provided that Appendix B should be mandatory only for producers with company-wide jurisdictional sales of over 10,000,000 Mcf per year in distinction to the prior minimum of 2,000,000 Mcf. As to smaller producers a new questionnaire, Appendix C, was created, and those with less than 10,000,000 Mcf per year of jurisdictional sales were required to answer either Appendix B or Appendix C (A. IX/62d). Several small producers requested that they be exempted from answering the questionnaires; however, these requests were categorically denied (A. Supp./16s).

Because of the burden of proceeding to hearing on the economic data on October 11, 1961, and the further burden of preparing the extensive questionnaire data, while much of the same material had already been submitted and the same issues tried in individual hearings, Sun on September 26, 1961 sought review of the Commission's order providing for hearing and the filing of such data. The appeal was dismissed as interlocutory, however, *Sun Oil Company* v. *Federal Power Commission,* 297 F. 2d 77 (5th Cir. 1961), and the hearings on economic data commenced while the questionnaire data was prepared and compiled.

During the course of compilation of the responses received to the questionnaires, the State of California and its Public Utilities Commission filed a motion with the Commission seeking advance copies of the responses. Certain producers objected on the ground that the information would be used for rate base cost-of-service studies in contravention of the Commission's April 5, 1961 order. By an order issued May 14, 1962, the Commission ruled that the responses should not be made available to the parties until all of the material had been composited. As to the argument that California sought the information in order to introduce rate base cost-of-service data, however, the Commission reversed its April 5, 1961 order to the extent that it held that it would now permit such studies on a composite basis. The Commission remained firm, however, that cost-of-service studies for individual producers would not be permitted (A. IX/66d-68d).

B. Hearings

The hearings in these proceedings commenced on October 11, 1961 with the presentation of economic evidence. The cost phase of the case commenced later with a presentation by the Commission Staff on September 5, 1962. Among the evidence presented in the cost phase were the two composite cost-of-service approaches eventually adopted by the Commission as the basis for a two-price system of rates in the Permian Basin. One of these approaches, commonly termed the "historical cost-of-service" or "cost of flowing gas" consisted of a compilation of certain of the limited number of responses received from Appendix B and C questionnaires sent out to respondents to the proceedings. This historical cost-of-service approach was principally advocated by the Commission's Staff and was placed in the record by Staff witnesses who had compiled the answers to the questionnaire. Producer personnel who prepared the answers were not made available for cross-examination on the basic figures contained in their individual responses.

The other cost-of-service approach eventually adopted was principally advocated by two witnesses for the California intervenors, Alfred Kahn and Herman G. Roseman. The latter assembled the cost-of-service from a combination of widely diverse sources. These sources included the compiled responses to the questionnaires that formed the basis for the historical cost approach, and in addition statistical data derived from Census Bureau reports and various surveys of trade magazines, industry committees, trade associations, and financial houses. This approach has been commonly referred to as the determination of the "current cost of gas" or "cost of new gas."

As the hearings progressed it became increasingly apparent that the responses to the questionnaires by no means covered the operations of all producers in the area as the Commission had directed. Nor were they a representative sampling. It also became evident that the witnesses who had composited the responses had a singular lack of knowledge of the basic data behind such responses, and they were unable to explain patent anomalies on the face of the data much less being qualified to testify as to its accuracy or to be cross-examined thereon. Accordingly, Sun by a motion filed February 28, 1963, moved that the composites be stricken. Also, because of this failure of proof as well as the Commission's basic lack of power to undertake group rate making in the manner that had been presented on the record, Sun moved that the proceeding be dismissed (R. 273958). No answer was filed to the motion and no ruling was forthcoming by the Examiner. Sun renewed its motion on September 12, 1963 (R. 274245), and it was again ignored by the Commission Staff and the Presiding Examiner. Additionally, Sun's motions were ignored by the Commission when they were renewed in the exceptions Sun took to the Presiding Examiner's decision (R. 275976).

Sun's aforementioned motions cited a number of examples of anomalies in reporting and the inability to cross-examine on these matters. Also at a later stage of the proceedings—shortly after the close of the evidentiary record, but while the case was still pending before the Examiner—further evidence became available showing the absence of compatibility in the basic data and the need for cross-examination thereon. Sun moved that the record be reopened to admit such evidence (A. Supp/20s-34s). This new

evidence consisted of responses to a "counter-questionnaire" circulated in the subsequent Area Rate Proceeding, Docket No. AR61-2, which showed extensive disagreement among the respondents therein (including a substantial number who were also respondents in the instant Docket No. AR61-1) as to the meaning of certain key questions in the appendix questionnaires circulated by the Commission. These responses confirmed Sun's contentions that the answers to the questionnaire were inconsistent and incompatible.

The Presiding Examiner denied Sun's motion to submit the additional evidence of incompatibility. The ground for the denial was that "the validity of the Staff questionnaire data can be evaluated on the evidence in this record" (A. Supp/35s-37s), an apparent reference to the Examiner's intention to reject the Staff's historical cost-of-service approach in the intermediate decision he was then preparing (A. IX/308d-311d, 341d). Nevertheless, the Examiner made extensive use of the composite of historical costs derived from the appendix data as it was incorporated in the current cost study which he adopted. Accordingly, Sun renewed its motion to reopen the record in the exceptions it filed to the Examiner's decision (R. 275981). As in the case of Sun's motions to strike and dismiss, however, Opinion No. 468 ignored the motion to reopen the record to consider the "counter-questionnaire." Moreover, the composited and averaged appendix data which was shown to be incompatible by the new evidence, form the very foundation of the rates fixed by Opinion No. 468, and the Opinion all but ignores the vital evidentiary questions Sun's motions raise.

Notwithstanding the Commission's restrictive rulings in its orders prior to hearing and a ruling by the Examiner sharply limiting the purposes for which individuals could submit cost studies,[6] several producers, including Sun sought to make presentations of their individual costs. All such individual cost presentations were rejected however, on the ground that they "* * * relate to an individual company presentation and are therefore excluded from this proceeding under the perimeters of the case set forth by the Commission in its orders, * * *" (A. V/1906).

Further, in accord with the Commission's policy against individual presentations enunciated prior to hearing, the Presiding Examiner rejected evidence that in another proceeding, 45 days prior to Staff's introduction of the composite data in the proceedings herein, Staff witnesses had determined Sun's over-all unit cost to be in excess of the price Staff recommended in these proceedings (A. IV/1166-1170). Sun sought to introduce this evidence in the course of cross-examination of a Staff witness who had submitted an array of purported costs of the individual companies whose cost data made up the composite upon which the rates were fixed. The arrays had been submitted with the individual company data thereon identified only by code numbers (A. VII/493e-533e), and the Examiner sustained an objection of Staff Counsel who argued that the identity of individual companies in the array was irrelevant even when identified as part of an at-

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[6] The Examiner ruled that individual data could be presented "which is relevant to the determination of an area rate versus evidence in justification of a particular company's or enterprise's rates" (A. III/1080).

tempt to discredit the costs attributed to individual companies in the array (A. IV/1168-1169).

Sun also submitted evidence to show that the responses to the appendix questionnaire as compiled by Staff were not properly usable in allocations that formed the basis for the Staff's cost of service study, since the responses were not a random sample of the whole Permian Basin, but were instead biased by the exclusion of smaller producers. Moreover, it was mathematically shown that the basic data that was obtained was so widely spread and skewed from the mean that volumetrically weighted averages were not representative of the data. This testimony was presented by John D. Rice, an experienced professional mathematician (A. V/1622-1625) and was unrebutted. Furthermore, the testimony was largely corroborated by other statistical testimony from a witness for the California intervenors as to the need for a random sample (A. I/364-367). Nevertheless, Rice's presentation was unmentioned in the Commission's Opinion No. 468, and its substance was totally ignored.

C. Presiding Examiner's Decision

On September 17, 1964, the Presiding Examiner issued his decision (A. IX/97d-364d). The Examiner did not discuss or make findings on the legal foundation for the area rate approach other than a passing reference to the need for relief from confiscation by some unstated procedure for price adjustment or abandonment (A. IX/264d). Also the Examiner made no findings justifying the area involved as an economic unit for fixing rates. Instead, the Examiner proceeded to fix purported over-all area rates for the large producers in the Permian Basin and found the contract

rates of small producers to be just and reasonable or in the public convenience and necessity. In fixing rates for the large producers the decision first recognized that the price permitted to be charged by a producer is a measure of the producer's incentive to find and produce new reserves. On this basis it determined that there should be a two-price system of regulation, one price which recognized the "current" (1960) cost of finding new gas on an over-all average basis and a second price which compensated the producers as a group for the costs related to existing or old gas, also on an over-all or average basis.

In determining the prices to be applicable in the area the Examiner adopted the aforementioned current cost of gas approach of Kahn and Roseman to find a purported nation-wide cost-of-service for new gas in 1960. This was translated into a cost of old gas by an index purportedly relating to 1960 drilling costs the average for the years 1948 through 1959 and into Permian Basin revenue standards and prices by "value consideration"—a euphemism for negotiated prices.

Notwithstanding the use of many elements of the historical cost-of-service in preparing the current cost-of-service that the Decision adopted, the Presiding Examiner's Decision nevertheless rejected the composite historical cost-of-service devised by the Commission Staff and roundly criticized it as being incomplete and unrepresentative (A. IX/308d-310d), and so interlarded with assumptions and tenuous and involved allocations as to be costs in name only (A. IX/341d).

D. The Commission's Opinions and Collateral Orders

Numerous briefs on exceptions were filed with respect to the Examiner's decision, and the Commission on August 5, 1965, issued Opinion No. 468 here under review (A. X/516d). This Opinion was followed by the Supplemental Opinion No. 468-A issued October 4, 1965 (A. XI/1105d), which modified Opinion No. 468 in certain respects, but for the most part denied the many applications for rehearing that had been filed. Several collateral orders were also issued, including an order issuing and conditioning certain certificates of public convenience and necessity and an order to show cause why the Opinion 468 rates should not be applied in the case of a number of producers who had not been the subject of investigation in Docket No. AR61-1 and in the case of a number of rate increase dockets which had not been consolidated with Docket No. AR61-1.

In Opinion No. 468 the Commission sought to justify the area rate approach from a legal standpoint, principally by reference to *Second Phillips,* by the claim that the method was adapted to the economics of the industry, and by citing several instances involving other statutes and other industries where some manner of group price fixing approach was undertaken (A. X/541d-552d). The Opinion in no way sought to justify the Permian Basin as a proper economic area for group rate making.

In substance Opinion No. 468 adopted a two-price system of the type set forth in the Examiner's Decision and fixed a ceiling price for gas-well gas and residue from gas-well gas contracted for after Jan-

uary 1, 1961 at 16.5 cents per Mcf. This price was based on a current cost of gas study such as that adopted by the Examiner. For gas-well gas and residue from gas-well gas contracted for prior to January 1, 1961 a ceiling price of 14.5 cents per Mcf was set. The same ceiling price was also set for casinghead gas [7] and residue from casinghead gas whatever the contract date. The 14.5 cents per Mcf price was fixed on the basis of the historical cost-of-service approach advocated by the Commission Staff and rejected by the Presiding Examiner as unrepresentative and requiring many tenuous allocations.

With regard to the problem of representativeness the Commission claimed that it achieved representativeness by ignoring costs of those small producers who chose to respond to the Appendix C questionnaire (A. X/629d-630d). Similarly, a number of the allocations were avoided by ignoring evidence of the cost of producing casinghead gas and gas-well gas from combination leases and fixing the rate for this gas at the gas-well gas level.

The costs used in determining the ceiling price for both old and new gas did not include any portion of the producers' cost for transporting the gas to a central sales point in the field and of processing the gas to remove impurities and liquid hydrocarbons. Also there was no allowance for the cost of achieving minimum quality standards which the Opinion provided must be met or compensated for by way of quality differential reductions from the ceiling prices. Furthermore, there was no finding in the opinion that the costs that had been found would be recovered by

[7] Gas produced in association with oil.

revenues derived from the rates that had been fixed. In this regard the Commission in Opinion No. 468-A held that it would not allow higher prices than the ceilings it had fixed in order to compensate for revenue deficiencies resulting from producer contract prices that are below the area ceilings (A. X/1114d). To virtually the same effect in the case of rates collected subject to refund, Opinion No. 468 required the refund of past revenues collected in excess of its ceiling prices with no offset for rates collected during those refund periods that were below the ceiling prices.

Another aspect of Opinion No. 468 was the provision for a moratorium preventing producers from filing contractually authorized rate increases for a period of 2½ years beyond September 1, 1965 (A. X/660d-669d). By reason of the moratorium ceiling prices purported to be based on a test year of 1960 would be imposed for a period of about 11 years—three years before and seven years after the test year.

Finally, the Opinion mentioned the possibility of relief for individuals, but only at the Commission's sole discretion and at some unspecified time in the future. Furthermore, the Commission stated that "we will not permit a back-door approach to individual cost-of-service under the guise of avoiding confiscation" and "more must be shown than that the individual producer's costs exceed composite costs" (A. X/551d.) The only exact circumstance mentioned that might merit relief was in the event out-of-pocket costs exceeded revenues from a particular well. Even then the Opinion indicated that the relief may be afforded by permitting the abandonment of the delivery (A. X/656d-660d).

E. The Proceedings on Appeal

Following issuance of Opinion Nos. 468 and 468-A, individual appeals were taken pursuant to Section 19(b) of the Natural Gas Act [15 U.S.C. § 717r(b)] by Sun and a large number of other producers, as well as by the States of Texas and New Mexico. The appeals were heard by the Court of Appeals for the Tenth Circuit in view of the first filing of a petition for review with that Court by Skelly Oil Company, located in that Circuit. Other appeals were subsequently transferred to the Tenth Circuit pursuant to the provisions of 28 U.S.C. 2112(a), or were filed therein by acquiescence of the Commission. The State of California, and several California natural gas distributing companies and municipalities were permitted to intervene.

In its appeal Sun pointed out that from a constitutional and statutory standpoint rates fixed pursuant to the Natural Gas Act must be just and reasonable as to the individuals regulated, and in accordance with the minimal criteria set forth in a long series of cases under the Natural Gas Act, the rates fixed must afford individuals regulated the opportunity to recover their operating expenses and capital charges. With this the case, Sun showed that group rate making which ignored the individual was not appropriate under this statute, as this Court had previously found in *Bowles* v. *Willingham,* 321 U.S. 503, 517 (1944); however, group ratemaking could be undertaken if adequate consideration were given to the individual. Thus, in the *New England Divisions* case, *Akron, C. & Y. R. Co.* v. *United States,* 261 U.S. 184 (1923), this Court held that evidence of the group used in fixing rates must be typical and representative. Also, the individual

must be afforded the opportunity to rebut any claim that the group evidence used is typical and representative as to itself and to except itself from the group rates on proper showing.

With respect to Opinion No. 468, Sun showed that since the Commission failed to make proper findings of typicality and representativeness of the basic data and the averages derived therefrom, it therefore failed to give any consideration to whether individuals could recover their operating expenses and capital charges at the rates fixed and failed to meet the requirements of the *Divisions* case. The Commission also precluded rebuttal to the basic data used and to the matter of typicality and representativeness. In addition it denied individuals the opportunity to show that the rates fixed were not typical and representative as to themselves or that the rates were confiscatory so that the individual could be exempted from the rates fixed. Sun also showed that, by reason of many due process errors arising from the use of evidence that could not be cross-examined or rebutted and the failure to fix or follow regulatory standards, such findings as were made were not supported by reliable, probative and substantive evidence as required by Section 7(c) of the Administrative Procedure Act, 5 U.S.C. § 1006(c).

Other issues presented by Sun and others in the appeal were that the Commission erred in its failure to fix group rates which would recover the group costs including the costs associated with quality differentials and gathering and processing costs. Also the Commission erred in failing to consider evidence and make findings as to the area fixed, and the Commission erred in providing a moratorium on rate filings.

F. The Determinations of the Court Below

Initially the Court of Appeals, after a preliminary argument by counsel for Skelly Oil Company and the Commission, issued a temporary stay and provided for further written and oral argument on specified issues pertaining to the stay (A. XII/1-2).[8] Following such further argument the court granted a stay and provided that any excessive revenues collected pending the litigation and commingled with company funds should be refunded with 4½% interest (A. XII/8-14).

The court of appeals' decision issued January 20, 1967 (A. XII/15) remanded the case to the Commission because the Commission failed to equate group revenues to be achieved with group costs found, including costs associated with quality differentials. This, the court held, is not in accord with the "end result test" of *Federal Power Commission* v. *Hope Natural Gas Company,* 320 U.S. 591 (1944).

Similarly, the court of appeals in its opinion on rehearing issued April 18, 1967 (A. XII/87) held that in considering refunds the Commission must give effect to balancing revenues received during the refund periods with revenue requirements measured by the ceiling prices.

In addition, the court recognized that the individual must be afforded the opportunity to show the impact of the rates fixed on itself and on this basis the court remanded the proceeding to the Commission for the development of definitive standards and a tangible

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[8] The issues that the court stated it would consider were: (1) the injury to producers, (2) the injury to others, including the public and those intermediate between the producers and the public, and (3) what protective devices can or should be ordered to prevent such injuries in the event of either the grant or denial of a stay.

procedure by which the individual might make such a showing. Moreover, the court provided that the aggrieved producer should be heard promptly and the general rate order should be stayed as to that individual until it had been heard. The court held that such a procedure should do more than protect against unconstitutional confiscation and suggested that among the issues that could be considered were the absence of evidence that is typical and representative of the individual, and the failure to allow processing and gathering costs (A. XII/50-51). Nevertheless, the court suggested that expense items contained in an individual cost-of-service including dry hole expense are not to be included in a measure of a confiscatory rate (A. XII/49).

With respect to the fundamental question of the Commission's power to enter upon group rate making, the court held that the Commission has such power, apparently based on the proposition that the Commission is not bound by any ratemaking formula and on the impression that the method was required by the necessities of procedure and administration (A. XII/35-37). The opinion thus did not relate the power to fix group rates directly to the fundamental constitutional and statutory limitation that the individual must be afforded the opportunity to recover its operating expenses and capital charges. Nevertheless, the court did in effect recognize the validity of this proposition in holding that group revenues must recover group costs and that group costs must be typical and representative both as to the basic data and the averages obtained therefrom (A. XII/44-46).

Despite the court of appeals' recognition that the typical and representative criteria are appropriate

and its further recognition that weighted averages are suspect in making typical and representative determinations, the court below did not discuss Sun's contentions that there were no adequate findings of the typicality and representativeness of basic data and averages and no analysis or support for such findings that were made. Rather, the court relied wholly on the expertise of the Commission in this regard (A. XII/46). This complete acceptance of the Commission's "expertise" was apparently part of the court's refusal to review a number of important evidentiary issues such as the Commission's reliance on hearsay evidence in the form of untested questionnaire responses, the deprivation of the right of cross-examination, and other matters of procedural due process. To consider these issues, the court stated, would increase its opinion to "encyclopedic dimension" and draw it into "a turmoil of numbers." Therefore, the court below confined its opinion only to what it termed "errors of law" (A. XII/40-41).

SUMMARY OF ARGUMENT

The fundamental question in this first Federal Power Commission entry into group rate making is whether there are limitations on the Commission's discretion; what are those limitations, and has the Commission honored them. The Commission has proceeded without limitation and seeks to justify its action by truncated citations of court holdings on the breadth of its discretion and by protestations of the difficulty of its task and the sincerity of its effort. It is Sun's view, however, that the limitations that would apply to the Commission have been precisely defined by this Court and otherwise applied in the regulatory field,

and the Commission's action should be reversed for its failure to adhere to those limitations.

A. Although the majority of this Court in *Second Phillips* expressed its view that a group method of regulating natural gas producers could be devised by the Commission, it did not hold that any type of group method which the Commission undertook would meet constitutional and statutory criteria. Also this Court was relying on the Commission's representations as to the nature of group rate making it was undertaking, rather than a review of what the Commission actually did. The Commission, however, apparently took *Second Phillips* as a statement of its unlimited discretion in group rate making and proceeded upon the theory that it would insulate itself from any evidence showing the impact of its action on either the individuals or the group. In so doing, the Commission completely disregarded this Court's prior holdings clearly defining the Commission's powers and imposing limits on group rate making under the Constitution and under a statute having the characteristics of the Natural Gas Act. The Commission also ignored representations to this Court in the argument in *Second Phillips* that it would devise a procedure to protect the individual against confiscation.

B. In accordance with the holdings of this Court individuals having a substantial capital investment and subject to restrictions against abandonment are constitutionally protected against a "taking of property," otherwise termed "confiscation." Confiscation has been defined as the failure to allow the regulated enterprise the opportunity to recover its cost-of-service consisting of its operating expenses and capital

charges,[9] and the *Hope* case[10] adheres to this as the minimum "end result." Accordingly, the fixing of rates that will afford the opportunity to recover a cost-of-service made up of operating expenses and capital charges is a positive constitutional requirement, and costs are not some vague "yardstick" that can be "reasonably related" to revenues as the Commission would have this Court believe with its argument that it need only provide a "fair accommodation" of consumer and investor interests.

C. From a constitutional and factual standpoint producer regulation presents an entirely distinct situation from other group regulation cited by the Commission in Opinion No. 468. Unlike group regulation in the minimum price cases and the market agency cases, the Natural Gas Act provides for the fixing of specific prices, precludes abandonment without authorization, and involves the regulation of enterprises having very substantial investments. Unlike the communications industry where the Federal Communications Commission applies its "bellwether" method of group rate making, the fixing of a rate for one producer does not result in a rate which all producers will meet, thus making industry-wide rates an inescapable fact and the "bellwether" method a workable method of fixing group rates. The railroad industry and the airlines industries are economically similar to the communications industry so that industry-wide rates

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[9] This assumes that those operating expenses and capital charges are prudent, and competitive circumstances will permit the charging of rates that will recover the cost-of-service. In the instant proceedings there is admittedly no evidence of imprudency, and there is no dispute that the gas can be sold at the contract rates sought by the producers.

[10] *Federal Power Commission* v. *Hope Natural Gas Company*, 320 U.S. 591 (1944).

for the same services are essential. Also, they are governed by statutes especially designed for group rate making. The Natural Gas Act on the other hand is designed for individual regulation as is evident from its clear language, this Court's prior decisions, and the contrast of its provisions with those of the statutes designed for group regulation.

D. A statute designed for individual regulation such as the Natural Gas Act, may be reconciled with a system of group rate making if there is correlation between the experience of the group and the experience of individuals in the group. On the basis that there is this correlation the constitutional minimum that the individuals must be afforded the opportunity to recover their operating expenses and capital charges is also applicable to fixing rates for the group. This is in accord with the principles utilized by the Interstate Commerce Commission in group rate making prior to the Transportation Act of 1920, which are set forth in the *New England Division Case.*[11] Group regulation in that case was predicated on findings that the group evidence used was typical and representative of the individuals in the group. In addition, the *Divisions* case held that any company could avail itself of a savings clause which allowed the company to except itself from the order, in whole or in part, on proper showing (261 U.S. at 196-199).

E. The erroneous and superficial discussion of the law governing group rate making in Opinion No. 468 and the Commission's brief shows that the Commission did not properly evaluate its limitations and obligations under group rate making, and did not even con-

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[11] *Akron, C. & Y. R. Co.* v. *United States,* 261 U.S. 184 (1923).

sider the typical and representative approach to group rate making approved by this Court. On this basis alone the case should be remanded. A further review of the Opinion and the proceeding discloses the extent to which the criteria of a proper group rate making method were not met.

F. The Opinion failed to use typical and representative evidence in deriving the historical gas costs and portions of the new gas costs because of its reliance on data from some of the responses to a questionnaire sent out on a nonrandom basis. Through a combination of the Commission's failure to send questionnaires either to all producers or to a representative sample of producers, its failure to use its processes to obtain sufficient or usable answers and its rejection of many answers that were received, the basic data initially composited by the Staff was unrepresentative, as testified to in the record and found by the Presiding Examiner. To compound this unrepresentativeness, the Commission in Opinion No. 468 rejected the responses of a number of other producers as well as data concerning casinghead gas, and gas from combination leases. As a consequence the Commission finally found costs for old gas based on responses from only some 40 out of over 2000 producers and from only 15% of the gas production in the Permian Basin.

G. Beside the unrepresentativeness of the data used there is serious question as to its compatibility, and hence its capability of being composited as the Commission did in fixing the rates. Yet, the Presiding Examiner's rulings, based on the Commission's strict holdings that individual presentations should be avoided, precluded cross-examination of persons that prepared the data and even the identification of the

individual companies in exhibits where their purported costs were ultimately set forth. Also rejected were rebuttal presentations that would have confirmed the lack of compatibility of the questionnaire responses and shown the inaccuracy of the costs attributed to particular companies. Finally, repeated motions to strike the data because of these denials of due process were simply ignored.

H. In addition to the above deficiencies in the representativeness and compatibility of basic data the weighted averages derived by the Commission were not shown to be representative. This serious question is nowhere treated in the Opinion, although this Court has many times recognized the suspect nature of using weighted averages alone to obtain representative results, particularly where the data being averaged is widely dispersed as is the case here.

I. As previously noted the above errors which result from use of questionnaire response data apply to both the old and new gas determinations. There are also other errors in the new gas cost determination. These include the use of surveys by trade magazines, industry associations, investment banks, the representativeness of which was in no way established; the use of data from several other sources having widely diverse coverages, and the use of data sources in certain aspects of the study which were otherwise rejected in the study as being unrepresentative. In addition costs reported by the Census of Mineral Industries were extensively used in the new gas cost determination although the Secretary of Commerce has reported to the Congress that these statistics would not be acceptable for financial purposes.

J. The Commission also failed to meet the criterion for group rate making requiring that individuals be provided an opportunity to show that the group rate should not apply to them. All evidence of individual costs presented in hearing to support some relief was summarily rejected, and the Commission's suggestion of possible relief in an indefinite future certainly does not satisfy the requirements set forth by this Court in the *Divisions* and other cases. The restrictions placed on such relief assure that no opportunity will be afforded to show confiscation or that an individual's costs are atypical of the group. Moreover, the moratorium provision precludes the filing of rate increases in the event changed conditions result in the need for added revenues.

ARGUMENT

INTRODUCTION

The basic issue that pervades these proceedings is simply whether the Federal Power Commission in regulating the rates of natural gas producers is to be held to constitutional criteria for rate making and the statutory standards of the Natural Gas Act as interpreted by this Court over an extended period of years, or whether those principles may be ignored or rewritten to ease the Commission's task. As such this case is not the conflict of group regulation against individual regulation toward which the Commission has directed so much of its argument. Rather it presents the question of what restrictions properly apply to group regulation in the circumstances it has been applied and whether the Commission has honored those restrictions.

If the Commission's attitude toward the proceedings may be characterized, we submit that it is that

the Commission is without restriction, beyond some amorphous limit of the reasonableness of its discretion, which it alone has the expertise to judge. On the other hand, Sun contends that notwithstanding the Commission's broad discretionary powers, there are precise limits which have been well defined by the Congress, by other regulatory agencies, and by this Court. The Commission has totally ignored these limits.

This brief will be divided into two main sections. In the first, it will be shown that the Commission did not properly conceive of the law of group rate making and on this basis alone its Opinion No. 468 should be reversed and remanded for proceedings predicated on a correct interpretation of the law. In the second section it will be shown that as may be expected since the Commission did not correctly conceive of the law of group rate making, it also did not properly apply the law of group rate making.

PART I

THE COMMISSION DID NOT CORRECTLY CONCEIVE THE LAW OF GROUP RATE MAKING

I

THE COMMISSION SEEKS TO SUPPORT ITS AREA APPROACH BY PROTESTATIONS OF ITS REGULATORY PROBLEMS, BY SUPERFICIAL CITATION TO GROUP REGULATION OF OTHER AGENCIES AND BY AN ATTEMPT TO EXPAND THIS COURT'S HOLDING IN SECOND PHILLIPS, RATHER THAN BY CLEAR CUT ANALYSIS OF THE APPLICABLE LAW, THE EVIDENCE OF RECORD AND THE COMMISSION'S ACTION

The Commission in Opinion No. 468 attempts to justify the area approach it has adopted by citing a number of instances where other agencies governed by other statutes have undertaken group rate making for other industries (A. X/543d-545d). The Commission also quotes from this Court's decision in *Second Phillips* (A. X/540d, 541d) which held that the Commission had not abused its discretion in terminating a proceeding in contemplation of embarking upon a group method of fixing rates. The Commission then cites portions of other cases which hold that it is not bound by any special ratemaking formula (A. X/545d), and refers to several reasons why it chose the area approach over the individual approach which it had tried and found wanting (A. X/546d-551d). The briefs of the Commission, the State and Public Utilities Commission of California, the California Distributor Group and the City of Los Angeles seek to expand on these themes, but for the most part do not materially vary from them.[12]

Sun does not dispute that a number of other agencies acting under other statutes have undertaken group

[12] References to these briefs will be as follows: Commission, Comm. Br.; California, CPUC Br.; the California Distributors, Cal. Dist. Br.; Los Angeles, L.A. Br.

regulation. Neither does it seriously question that there are procedures by which group rate making could be undertaken under the Natural Gas Act, or that there are many imponderables and aggravations of individual regulation which make the prospect of a limited number of summary hearings most attractive. Yet these truisms do not justify the course of action undertaken by the Commission in this case.

The group ratemaking cases cited by the Commission cannot be simply accepted as justification for the Commission's action, nor can they be as readily rejected as did the Tenth Circuit because translation from one statute to another is treacherous business (A. XII/33-34). Instead those cases, along with many others, must be carefully gleaned for applicable principles. As will be shown, these cases reveal definite limitations on the Commission's rate making powers, which the Commission has ignored.

Similarly, neither this Court's statements in *Second Phillips* nor the vigorous dissent can be accepted as conclusive of the Commission's power or lack of power to fix area rates as undertaken. Examination of the briefs and decision in that case[13] fails to reveal a single reference to the cases or concepts which most clearly limit and define the Commission's group rate making powers, and which the Commission has ignored or misinterpreted.[14]

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[13] Nos. 72, 73, 74, October Term, 1962.

[14] For example, among many other pertinent cases not found, there is no reference to *Bowles* v. *Willingham*, 321 U.S. 503 (1944), which prescribes several important constitutional limitations on group ratemaking or to the *New England Divisions Case, Akron, C. & Y. R. Co.* v. *United States*, 261 U.S. 184 (1923), which sets forth the criteria for group ratemaking where a statute provides for individual regulation as does the Natural Gas Act.

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Even if this Court had finally approved the Commission's concept of an area approach in those proceedings, however, it did not, of course, have the record of these proceedings before it and could not have conceived that the area rates would be determined upon basic data and weighted averages which are neither representative nor typical; that the data used which purports to be the operating expenses and capital charges of the group could be remote from the experience of individuals in the group; that those individuals would be denied the opportunity to show this through cross-examination or rebuttal, and that revenues from the rates fixed admittedly would not recover even those costs that were found. Furthermore, this Court is referred to a colloquy in the argument before the Supreme Court in *Second Phillips* where the Commission's General Counsel advised the Court that the Commission would have to set up a procedure to ascertain if the rates fixed are confiscatory as to an individual (Transcript of Argument, p. 65).[15] As Sun will show, the procedure for relief from area rates set up by the Commission does not accord with the General Counsel's statement since confiscation is certainly not to be a test for relief.

As to the other cases cited by the Commission to show the extent of its discretion in rate making, Sun

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[15] Justice Black: "Suppose you fixed the rate at 15 per unit, whatever—15 cents per unit. And one fellow comes in and says that is all right, but most of them say I can't operate without losing my business. This is confiscation to me. What happens then? What will the Court have to do?"

Mr. Solomon: "First of all, the Commission would have to look into this problem. Obviously we are going to have to set up a procedure whereby a man who believes that there is confiscation can bring his claim to the Commission initially and then presumably to the courts."

will show that the Court has nevertheless in those cases imposed definite minimums on the rates that may be fixed. Indeed, these limitations are often stated in the portion of the decisions immediately proximate to the portions quoted by the Commission and those that support it. The quotations have been carefully truncated, however, to conceal these limitations.

The argument of purported need for group rate making with which the Commission in Opinion No. 468 seeks to support its action (A. X/547d-549d; Comm. Br. 48-55), is principally directed toward attacking an individual company approach to regulation and arguing that the method it has adopted conforms to an industry pattern where some producers make money and some do not. In the first instance, it should be noted that the Commission's arguments against an individual company approach are largely misdirected. The alternative Sun will principally discuss, is not an individual company approach. Rather it is a group approach which recognizes the effect on the individual, not by making findings as to each individual, but by using evidence that is typical and representative of the individual. Moreover, this method, which was ignored in the Commission's Opinion, has been applied by the Interstate Commerce Commission for 50 years or more and was reviewed and approved by the Court as recently as its last term.[16]

The Commission's argument that its group method conforms to the industry pattern (A. X/548d) is also open to serious question. Certainly, however, it is not support for a group rate making system that ignores the individual. The characteristic that makes the fix-

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[16] *Chicago & N.W. R. Co.* v. *The Atchison, T. & S.F. R. Co.*, 387 U.S. 326, (1967).

ing of a single ceiling price appropriate in other industries is lacking in the natural gas producing industry. In those industries each entity must meet a single industry price if it is to remain in business,[17] and regulation is substituted for whatever other forces had previously fixed that price.[18] In contrast the pattern of the natural gas producing industry has been a myriad of prices resulting from individually negotiated contracts which give effect to such diverse matters as the size of the dedicated gas reserve, location of the reserve in proximity to the pipe line, pressure, deliverability, hydrocarbon content, impurities, depth of the reserve, cost of drilling and production, and size and nature of gathering facilities required. Where an industry pattern is to negotiate individualized arrangements this Court has recognized that regulation should be by review of those individualized arrangements rather than the *ex parte* fixing of a group rate, *United Gas Pipe Line Company* v. *Mobile Gas Service Corporation,* 350 U.S. 332, 338-339 (1956).

As to the Commission's further argument that group rates conform to the industry pattern because some producers would make money and some would not (A. X/548d), Sun submits that it is far different for a company to lose money because of the combined forces of its costs, the volume of product it has available to sell and the price at which it may competitively sell its product, than it is for a company to lose money because a regulatory agency has imposed on it a price

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[17] *Cf., Dayton-Goose Creek R. Co.* v. *United States,* 263 U.S. 456, 479 (1924); *Postal Telegraph-Cable Company,* 5 FCC 524, 528-530 (1938).

[18] *Tagg Bros. & Moorhead* v. *United States,* 29 F. 2d 750, 751-752 (D.C., Nebraska 1928), affirmed 280 U.S. 420 (1930).

at which it cannot possibly make money. This is particularly the case where the company must continue its sales notwithstanding the reduced price.

Because of a regulatory agency's potential for decreeing the economic life or death of a regulated entity, as discussed above, such agencies have been limited in their ratemaking powers so as to prohibit their reduction of contract rates below levels that would recover operating expenses and capital charges. Furthermore, this limitation is effective whether the agency regulates on an individual or group basis. This analysis, Sun submits, is fully supported by the many holdings of this and subordinate courts which will hereinafter be discussed. It is additionally a pattern of regulation that has been developed during the period of a great many years and has been used in the regulation of numerous industries by numerous regulatory agencies, state and Federal. Sun submits that the immediate problems of the Federal Power Commission in regulating natural gas producers, no matter how vexing, do not in any way justify a departure from these fundamental principles or a recasting of them.

II

THE AREA APPROACH OF OPINION NO. 468 CONFLICTS WITH THE CONSTITUTION IN ITS FAILURE TO GIVE EFFECT TO THE INDIVIDUALS BEING REGULATED

A. Constitutionally, the Individual Cannot Be Ignored in Fixing Group Rates for Producers Under The Natural Gas Act

The Commission rejects any notion that the effect on the individual regulated is a consideration in fixing area rates. To this same effect the Commission and its Examiner consistently throughout these proceedings ruled against efforts to cross-examine or to sub-

mit evidence showing the effect of the proposed rates on the individuals being regulated. In support of this restrictive character of its proceeding, Opinion No. 468 claims that certain cases it cites "* * * make clear that there is no constitutional infirmity in the statutory authority to fix just and reasonable rates on an area basis, and argue persuasively that in group rate making individual costs cannot be controlling" (A. X/550d-551d; See also Comm. Br. 40, 64). This is not the case. Constitutionally, group rate making may be entered into without considering the individual only under specific circumstances, and these circumstances are not present with respect to producer regulation under the Natural Gas Act.

The substantial constitutional restrictions on group price fixing are revealed in large part by *Bowles* v. *Willingham*, 321 U.S. 503, 516-519 (1944), a leading case on war-time price control in which this Court upheld the constitutionality of rent ceilings. In that case it was argued that a statute which does not provide a fair rental to each landlord is unconstitutional. This Court, however, held that the particular legislation involved [19] was constitutionally acceptable, pointing out that it was a war measure (321 U.S. at 519) and there was no taking of property since Section 4(d) thereof provided that "nothing in this Act shall be construed to require any person to sell any commodity or to offer any accommodation for rent" [20] (321 U.S. at 517).

The constitutional significance of provisions against abandonment in the usual utility statute was also recog-

[19] Emergency Price Control Act of 1942, 56 Stat. 23.

[20] See also a similar provision in price control legislation during the Korean conflict, Section 406 of the Defense Production Act of 1950, 64 Stat. 798, 807.

nized by this Court in *Hegeman Farms Corp.* v. *Baldwin,* 293 U.S. 163 (1934). There a wholesale milk dealer subject to minimum price regulation complained that by reason of competition the minimum was in fact a maximum and should be changed when the individual dealer could show that the effect of the minimum price was to deprive him of a fair profit. In response Justice Cardozo speaking for the Court stated as follows (293 U.S. at 171):

> "Much is made of a supposed analogy between the plight in which the appellant finds itself and that of public utilities subjected to maximum rates that do not yield a fair return. But the analogy, when scrutinized, is seen to be unreal. *A public utility in such circumstances has no outlet of escape. If it is running its business with reasonable economy, it must break the law or bleed to death.* * * *" (Emphasis supplied throughout unless otherwise stated.)[21]

The Natural Gas Act does not satisfy the constitutional conditions that would allow unrestrained group rate making, either as to the war power or the absence of restrictions on abandonment. The Act is predicated on the commerce power of the Constitution, *Federal*

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[21] The constitutional problem engendered by the abandonment section of the Natural Gas Act appears also to have given concern to Justice Jackson when he advocated a ceiling price approach to fixing the field price of gas in his dissent to the *Hope* case, *Federal Power Commission* v. *Hope Natural Gas Company,* 320 U.S. 591 (1944). While he contended that the constitutional problems associated with price fixing and rate-making are different, and the producer would have difficulty showing the invalidity of the fixed price as long as he voluntarily continued to sell, Justice Jackson nevertheless admitted that a different problem would be presented if the producer should withdraw and other authority were invoked to compel him to part with his property (320 U.S. at 652).

Power Commission v. *Natural Gas Pipeline Company of America*, 315 U.S. 575, 582 (1942), rather than the war power, and contemplates a permanent economic measure of a type readily distinguishable from war emergency legislation. See *Davies Warehouse Company* v. *Bowles*, 321 U.S. 144 (1944); *Block* v. *Hirsh*, 256 U.S. 135, 157 (1921).

As to the question of "taking of property," Section 7(b) of the Natural Gas Act, 15 U.S.C. 717f(b), in direct contrast to the price control statutes, requires Commission authorization prior to abandonment of facilities or service. Regulation under price control statutes which do not restrict an individual from leaving the business is certainly a far cry from the current situation in the natural gas production business. In the latter, a producer, after lengthy negotiations, enters a contract to sell his commodity at a price acceptable to him, but then is forced to reduce that price even though he is also forced to continue the sale for the remaining term of the contract, and thereafter as well.

Contrary to the impression that the Commission seeks to foster in the Opinion and its brief (A. X/658d-659d; Comm. Br. 62, fn. 36), the abandonment provision has been given substantial effect with respect to producers in the Commission's rules, 18 C.F.R. § 157.30, and in its cases—even where small volumes of gas were involved, *Harper Oil Company*, 23 FPC 2, 4 (1960); *Deep South Oil Company of Texas*, 25 FPC 734, 736 (1961); see also *Amerada Petroleum Corp.*, 29 FPC 218, 219 (1963). Moreover, the courts, including this Court, have upheld the applicability of the abandonment provision of Section 7(b) to natural gas producers, *Sunray Mid-Continent Oil Co.* v. *Federal Pow-*

er Commission, 364 U.S. 137 (1960); *Sun Oil Company* v. *Federal Power Commission,* 364 U.S. 170 (1960); see also *J. M. Huber Corp.* v. *Federal Power Commission,* 236 F. 2d 550 (3rd Cir. 1956), *cert. den.,* 352 U.S. 971 (1957).

Neither does the fact that the Commission has on occasion granted producers abandonment authorizations (Comm. Br. 62, fn. 36) detract from the primary provisions of the Act restricting abandonment. It is far different for a company to be able to terminate its operations at its sole discretion, before its reserves are depleted and its investment confiscated, than it is to cease service upon Commission authorization after hearing at which depletion and confiscation have been shown.

Another constitutional restriction upon group price fixing methods pertains to the extent of investment involved. This restriction was discussed in the *Market Agency* cases[22] which Opinion No. 468 claims to be cases arising "* * * under a statute with virtually the same rate-making provisions as the Natural Gas Act" (A. X/543d-544d; see also A. X/549d-550d, Comm. Br. 47).[23] As the Supreme Court pointed out, however, the market agencies were largely personal service activities requiring very little investment. Consequently, there was no question of a taking of property or confiscation from the level of rates fixed, *St. Joseph Stockyard Co.* v. *United States,* 298 U.S. 38, 49

[22] *Tagg Bros. & Moorhead* v. *United States,* 280 U.S. 420 (1930); *Acker* v. *United States,* 298 U.S. 426 (1936); *United States* v. *Corrick,* 298 U.S. 435 (1936).

[23] Also a *Market Agency* case, *Tagg Bros. & Moorhead* v. *United States,* was one of the few cited to this Court in support of group rate making in *Second Phillips* (Transcript of Argument, p. 66).

(1936); *Acker* v. *United States,* 298 U.S. 426, 434 (1936). In contrast, producer investment in gas wells and producing facilities runs into billions of dollars. Sun alone sought to show in these proceedings that its properly adjusted total net investment would be $296,858,897 (R. 34616-22), but was denied the opportunity to make such showing because this was ruled to constitute an individual rather than a group presentation.

B. The Commission Fails in Its Attempts to Constitutionally Support Its Group Method Which Ignores the Effect on Individuals in the Group

The cases cited by the Commission to show the constitutionality of the group rate making largely include cases that have been explained by the prior discussion. Thus the *Market Agency* cases (A. X/544d; Comm. Br. 47), involve a statute with no abandonment restriction and an industry where there is a small investment, while the minimum price cases (A. X/544d; Comm. Br. 48), *Nebbia* v. *New York;* 291 U.S. 502 (1934); *United States* v. *Rock Royal Co-op,* 307 U.S. 533 (1939); *Sunshine Anthracite Coal Co.* v. *Adkins,* 310 U.S. 381 (1940)[24] are explained by this Court's holding in *Hegeman Farms Corp.* v. *Baldwin, supra,* pp. 42-43. In the insurance case, *Aetna* v. *Hyde,* 275 U.S. 440 (1928) (A. X/550d; Comm. Br. 48), group

[24] The Bituminous Coal Act of 1947 provided for the fixing of maximum as well as minimum prices; however, its standard for fixing maximum prices was that "* * * no maximum price shall be established for any mine which will not yield a fair return on the fair value of the property" (310 U.S. at 397). Contrary to the impression given by Opinion No. 468 (A. X/544d) the regulation of maximum prices for coal was thus on an individual and not an area basis. Also the statute provided a specific limit on how far the price could be reduced.

regulation was undertaken pursuant to a statute that required "*en masse*" regulation affording a reasonable profit on "aggregate collections." This method was clearly distinguished from regulation under a statute whereby the superintendent of insurance would be authorized to determine whether "when applied to the Missouri business of the several companies or any of them, the existing or prescribed rates had been or would be just and reasonable" (275 U.S. at 446). The principles involved in the other cases cited will be subsequently discussed.

With respect to the Commission's further argument as to its reasons for a group approach (Comm. Br., 48-55) and its contention that the feasibility of regulation is a consideration in reviewing constitutionality of its group rate making (A. X/546d; Comm. Br. 57; citing *Bowles* v. *Willingham,* 321 U.S. at 517), the Court is respectfully referred to Sun's prior discussion on this point which shows that the Commission's arguments for its area approach are largely directed against individual regulation and do not consider a group method which gives effect to the individual (*supra,* p. 38). Also the Commission's collateral argument that its method conforms to the industry ignores significant differences that exist (*supra,* pp. 39-40). In any event Sun submits that feasibility of regulation cannot control where such other important elements militate against constitutionality of the Commission's group method, *i.e.,* the failure in any way to recognize the effect on the individual, the absence of the war power as a rationale, the restriction against abandonment in the statute and Commission practice, and the substantial investment of members of the group.

Finally, as to the Commission's citation to the proposition stated in the *Hope* case, 320 U.S. at 601, and

Bowles v. *Willingham,* 321 U.S. at 517-518, that regulation is not unconstitutional because it may reduce the value of the property (A. X/546d), the Court's statement must be examined in the light of its further holdings setting constitutional limits on the permissible extent of the reduction. Those limits will now be discussed.

III

THE CONSTITUTIONAL MINIMUM APPROPRIATE TO THE NATURAL GAS ACT COINCIDES WITH THE STATUTORY MINIMUM AND PROVIDES THAT THE INDIVIDUAL MUST BE AFFORDED THE OPPORTUNITY TO EARN ITS OPERATING EXPENSES AND CAPITAL CHARGES

As previously discussed group rates may not be fixed under the Natural Gas Act which will result in "taking the property" of individuals in the group. In other words there is a proscription against confiscation of the individual's property. Moreover, since the statutory standards under the Natural Gas Act coincide with the constitutional standard, *Federal Power Commission* v. *Natural Gas Pipeline Company of America,* 315 U.S. 575, 586 (1942), confiscation is also the minimum under the "just and reasonable" standard of the Act. The Commission, however, has throughout these proceedings sought to avoid the clear effect of this requirement that it must not fix rates that would confiscate the individual. Thus the Commission wholly disregarded the rights of the individual in fixing group rates. Now it argues with great emphasis on selected portions of the leading cases on the Commission's rate making powers which discuss Commission discretion in fixing rates, but completely ignores the clear holdings of the same cases which limit the breadth of that discretion and provide that as a minimum it must afford the opportunity to earn operating expenses and capital charges.

A. The Commission Ignores Limitations on Its Ratemaking Powers Clearly Stated in the Very Cases It Cites to Support Its Disregard of Individual Costs

In Opinion No. 468, the Commission cites *Hope, Federal Power Commission* v. *Natural Gas Pipeline Company of America,* 315 U.S. 575 (1942), and *Colorado Interstate Gas Company* v. *Federal Power Commission,* 324 U.S. 581 (1945), for the proposition that the Act imposes no special formula by which a "just and reasonable rate" is to be determined, and this Court held that would look to the result rather than the method (A. X/545d, 547d). Similarly, the briefs in support of the Commission quote copiously from these cases,[25] and the Commission brief emphasizes a statement from the concurring opinion in *Natural Gas Pipeline* that the consumer interest and the investor interest must be balanced in fixing rates (Comm. Br. 39). From this platform the Commission contends that rate making involves only a balancing of investor and consumer interests and the Commission is not prevented from "adopting any ratemaking method it reasonably deems adapted to the regulatory purpose, so long as the rates fixed under it represent a fair accommodation of the interests of the consumers and investors concerned." It then suggests that the Act does not ordain that each enterprise should recover its costs and a fair return (Comm. Br. 40).

Sun submits that the Commission has a myopic view of this Court's holdings in *Hope, Natural Gas Pipeline* and *Colorado Interstate.* The Commission thus ignores the circumstances of those cases, the interpretation given those cases in later decisions, and most important, the clear holdings of this Court otherwise

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[25] CPUC Br. 23-25; L.A. Br. 12; Comm. Br. 43-44.

in the same opinions. In the first instance it must be recalled that when these cases were decided the most important issue in regulatory law was whether an investment rate base could replace the long-entrenched fair value concept, and it was as to this issue that the Court was addressing itself when it held that no special formula should prevail and it would look to the end result reached rather than method.[26] In so holding, however, the Court did not leave the Commission without guidelines or standards as to the formula it could adopt; nor did it leave the end result undefined. Indeed, immediately following the statement in the concurrence to *Natural Gas Pipeline* cited by the Commission to support its unlimited power in adopting a method balancing its view of consumer and investor interests (Comm. Br. 39), Justice Black defined the minimum investor interest as follows (315 U.S. at 607):

> "The investor interest is adequately served if the utility is allowed the opportunity to earn the cost of the service. That cost has been defined by Mr. Justice Brandeis as follows: 'Cost includes not only operating expenses, but also capital charges. Capital charges cover the allowance, by way of interest, for the use of the capital, whatever the nature of the security issued therefor; the allowance for risk incurred; and enough more to attract capital.' Missouri ex rel. Southwestern Bell Teleph. Co. v. Public Serv. Commission, supra (262 US p. 291, 67 L ed 986, 43 S Ct 544, 31 ALR 807). Irrespective of what the return may be on 'fair value,' if the rate permits the

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[26] See *Los Angeles Gas & E. Corp.* v. *Railroad Commission*, 289 U.S. 287 (1933); *West Ohio Gas Co.* v. *Public Utilities Commission*, 294 U.S. 63 (1935); *West* v. *Chesapeake and Potomac Telephone Co.*, 295 U.S. 662 (1935), and particularly the local citations to these cases cited in *Hope* (320 U.S. at 602) as support for the "end result" doctrine, 289 U.S. at 304, 305, 314; 294 U.S. at 70, 79; 295 U.S. at 692, 693.

> company to operate successfully and to attract capital all questions as to 'just and reasonable' are at an end so far as the investor interest is concerned."

To the same effect this Court discussed the minimum of operating expenses and capital charges in virtually the same language in *Hope,* 320 U.S. at 603, and *Colorado Interstate,* 324 U.S. at 605. Moreover, this concept of using the cost-of-service made up of operating expenses and capital charges as a minimum or a "point of departure" has been recognized and applied in several important cases by the Court of Appeals for the District of Columbia, *Mississippi River Fuel Corporation* v. *Federal Power Commission,* 163 F. 2d 433, 450-451 (D.C. Cir. 1947); *City of Detroit, Michigan* v. *Federal Power Commission,* 230 F. 2d 810, 818-819 (D.C. Cir. 1955), *cert. den.,* 352 U.S. 829 (1956);[27] *D. C. Transit System, Inc.* v. *Washington Metropolitan Area Transit Commission,* 350 F. 2d 753, 778-779 (D.C. Cir. 1965).[28]

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[27] *City of Detroit* involved a case where the Commission sought to depart from a cost basis in determining a pipe line's cost of producing gas and adopt a value basis which would result in a higher return. Although, the D.C. Circuit held that the Commission could depart from the cost basis, it also held that costs were an "anchor" or a "point of departure" and the Commission must explain the need for allowances above cost. Sun submits that this case, along with *Colorado Interstate,* 324 U.S. at 601, effectively answers the issue that the *amicus curiae* brief of the Associated Distributors Group seeks to interject into this case by contending that costs must form the maximum as well as minimum of rate making.

[28] In a holding that is particularly apt to the instant case, Judge McGowan, in an *en banc* decision of the D.C. Circuit admonishes that a regulatory agency changing its method, even with statutory authority (350 F. 2d at 778), "should be disabused at the outset" of ignoring consideration of operating expenses and capital charges (350 F. 2d at 779).

The requirement that operating expenses and capital charges shall be allowed as a minimum in rate making is in accord with this Court's definition of confiscation, *Baltimore & Ohio R. Co.* v. *United States,* 298 U.S. 349, 356 (1936), and its holdings that confiscation results from the failure to allow valid expenses such as taxes, *Galveston Electric Co.* v. *Galveston,* 258 U.S. 388, 399 (1922); operating expenses, *Lindheimer* v. *Illinois Bell Telephone Company,* 292 U.S. 151, 164 (1934); depreciation, *Lindheimer, supra,* at 167.[29] Because of the failure to allow for these valid expenses, revenues must be diverted from satisfying capital charges. The amount available for capital charges, as measured by the rate of return, is hence rendered inadequate, and the allowed rates "are unjust, unreasonable and confiscatory," *Bluefield Water Works & Improvement Co.* v. *P.S.C. of West Virginia,* 262 U.S. 679, 690 (1923).

B. The Commission Seeks to Expand the Holdings of Other Cases to Support Its Disregard of Costs

In its "balancing of interests" theory of rate regulation, the Commission seeks to free itself from the standard of confiscation not only by ignoring the above definition of the minimum investor interest, but also by enlarging on the holdings of certain cases which involve obvious and reasonable caveats to the cost standard, but do not depart from it. In this regard it is wholly understandable that the costs allowed must not be unnecessary or extravagant as held by this Court

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[29] See also *Mississippi River Fuel Corp.* v. *Federal Power Commission,* 163 F. 2d 433, 451 (D.C. Cir. 1947), where it was held that allocation of costs was proper for a court to consider in examining the "end result" since the rates must yield enough revenue to meet all proper expenses.

in the *Market Agency* cases and *San Diego Land and Town Co.* v. *Jasper,* 189 U.S. 439 (1903), cited by the Commission (A. X/549d-550d; Comm. Br. 63). This, however, does not equate to a principle espoused by the Commission that costs in general can be ignored (A. X/549d) or that a particular producer's costs may be ignored because they are "high" (Comm. Br. 60-64).

In the instant proceedings the record shows that there is naturally to be expected a wide variation in costs (A. III/771-774), and there is no standard of prudent costs (A. III/770, 1105). Also a Staff witness testified that he could find no evidence that the actual costs expended were other than prudent (A. III/949). Accordingly, there is no basis for rejecting any producer's costs as unnecessary or extravagant simply because they are higher than costs of other producers.

For the general proposition that the Commission need not allow an individual's costs, and the further proposition that the investor interest is subordinate to the consumer interest without regard to any minimum for the investor, the Commission's brief relies heavily on selective language from *Covington & Lexington Turnpike Road Co.* v. *Sandford,* 164 U.S. 578 (1896) (Comm. Br. 39-40, 63). In full context, however, this case simply holds that a regulatory body need not allow costs if the resultant rate would price the product out of the market.[30] Thus the Court held that the establishment of new lines of transportation and the diminution of turnpike use was not in itself sufficient reason why unjust rates must be maintained to those who

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[30] See this more limited analysis of *Covington & Lexington* in Opinion No. 468 (A. X/550d).

must and do use the property (164 U.S. at 596).[31] Even then, however, the Court held that a minimum of what amounted to operating expenses and capital charges was appropriate.[32]

The inapplicability of *Covington & Lexington* to these proceedings is obvious from the fact that in accord with this Court's holding in *Federal Power Commission* v. *Sierra Pacific Power Co.*, 350 U.S. 348 (1956), the producers (even the high-cost producers) did not seek more than contract prices.[33] Hence there is no question that the gas can be sold to the pipe lines at the prices proposed. Moreover, there is nothing in this record to show that pipeline or distributor rates based on contract prices will in any way diminish the use of gas or make it unavailable to the public. In fact, gas has been sold at the contract rates, although subject to refund, for many years. Finally, the fact that contract prices recover less than cost does not warrant the fixing of rates which are still further re-

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[31] To the same effect see *Market Street Railway Co.* v. *Railroad Commission of California*, 324 U.S. 548, 563-564 (1945).

[32] "It is proper to say that if the answer had not alleged, in substance, that the tolls prescribed by the act of 1890 were wholly inadequate for keeping the road in proper repair and for earning dividends, we could not say that the act was unconstitutional merely because the company (as was alleged and as the demurrer admitted) could not earn more than 4 per cent on its capital stock" (164 U.S. at 596).

[33] The Commission and those supporting the Commission's order erroneously cite *Sierra Pacific* and seek to infer that producers seek more than contract prices (L.A. Br. 18-20; Cal. Dist. Br. 28; CPUC Br. 39, 50; Comm. Br. 93). This is not the case. Producers seek a ceiling rate which will give effect to inadequate revenues resulting from low contract prices in order that overall revenues may be adequate. They do not, however, seek to exceed the limits of their contract prices—either high or low—in order to do so.

moved from costs. This Court has long recognized that regulated companies can render service voluntarily for less than they could be compelled to accept, *Baltimore & Ohio R. Co.* v. *United States,* 298 U.S. 349, 358 (1936); *Federal Power Commission* v. *Sierra Pacific Power Co., supra* at 355.

IV

A PROPER COMPARISON WITH THE GROUP RATE MAKING PRACTICES AND EXPERIENCE OF OTHER FEDERAL REGULATORY AGENCIES FURTHER SHOWS THE LACK OF SUBSTANCE IN THE COMMISSION'S ATTEMPT TO SUPPORT ITS GROUP METHOD, AND REVEALS A METHOD FOR RECONCILING GROUP RATE MAKING WITH A STATUTE SUCH AS THE NATURAL GAS ACT WHICH PROVIDES FOR INDIVIDUAL REGULATION

It has previously been shown that the constitutional and statutory standards for rate making under the Natural Gas Act require that the individual regulated must be afforded the opportunity to earn its operating expenses and capital charges, and the Commission's efforts to justify a group method that would ignore both the individual and the cost-revenue relationship are unavailing. It will next be shown that in view of substantial differences in the statutes and the group methods devised by other Federal regulatory agencies, the Commission's citation to the experience of the FCC, ICC and CAB (A. X/544d-545d; Comm. Br. 47-48), to support its version of group ratemaking is superficial and erroneous. Nevertheless, the ICC in prescribing divisions of rates has upon specific conditions used a group method appropriate to a statute providing for individual regulation such as the Natural Gas Act. It is obvious from Opinion No. 468, however, that in attempting to justify its group method the Commission considered neither the method nor the conditions that method would impose.

A. The FCC's "Bellwether" Approach Is Not Adaptable to Producer Regulation and Does Not Support the Commission's Group Method

The genesis of group regulation in the communication industry is the simple fact that most competitive communication service is substantially uniform and no matter what the costs of a particular service it cannot be sold unless at a price level commensurate with that of a similar service offered by a competitor. Thus, if the service were priced in accordance with cost alone the business would go to the stronger carriers which would charge the lower rates, *cf., Dayton-Goose Creek R. Co.* v. *United States,* 263 U.S. 456, 479 (1924). Recognizing this the FCC has regulated by choosing one carrier of the group whose costs are such that if used to compute rates, those rates will provide a fair return for "a sufficiently large segment of the industry." Group rates are then fixed on the basis of the costs of that carrier which is termed the "bellwether" carrier, *The Western Union Telegraph Company,* 25 FCC 535, 577-580 (1958). Significantly, no instance has been found where a higher cost carrier has sought a higher rate for itself based on its own costs, since it would then price itself out of the market. Also, no instance can be found where the bellwether approach has been appealed, and it is difficult to conceive of the higher cost carrier appealing the FCC's determination which could be defended by pointing out that the same result could be achieved by simply fixing rates for the bellwether carrier alone based on the bellwether carrier's costs.

The Commission, of course, did not apply a "bellwether" approach to its regulation of producers and could not because of the differing industry character-

istics (*supra,* pp. 39-40). The Commission's citation of the bellwether method does not therefore support the method the Commission did use (A. X/544d).

B. The Natural Gas Act, Unlike the Statutes Governing the ICC and the CAB, Was Advisedly Designed for Individual Regulation as This Court Has Found

Group regulation by the ICC has also been marked by the need to fix a single rate because of the inherent nature of an industry which provides the same or similar services, *Dayton-Goose Creek R. Co.* v. *United States, supra.* For this reason the Interstate Commerce Act which originally provided for individualized regulation, *Fifteen Per Cent Case,* 178 ICC 539, 560-2, 564 (1931), was amended to provide for group regulation. Thus, the Transportation Act of 1920, 41 Stat. 474, provided in Section 15(a) of the Interstate Commerce Act a "Rule of Rate Making" which permitted the group method of regulation. In so doing, however, the Congress recognized the problem of the high cost carrier. Accordingly, the amendment further provided for recapture of revenues of carriers that exceeded a fixed rate of return, the excess to be made available to high cost carriers in the form of low cost loans and credits.

The new system of regulation prescribed by the Transportation Act of 1920, proved unworkable,[34] however, and the Interstate Commerce Act was further amended by the Emergency Railroad Transportation Act of 1933, 48 Stat. 211, 220. This Act provided a

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[34] For a discussion of the reasons of this unworkability see Aitchison, *The Evolution of the Interstate Commerce Act: 1887-1937,* 5 G.W.L. Rev. 289, 359 (1937), and the citations therein. See also *North Carolina* v. *United States,* 325 U.S. 507, 515, fn. 4 (1945).

new "Rule of Rate Making" listing a number of factors to be considered in ratemaking, 49 U.S.C. § 15 (a)(2). Obviously, this Rule of Rate Making is also directed to group rate making.

In contrast to the Interstate Commerce Act, the Natural Gas Act when enacted in 1938 contained no Rule of Rate Making, although many sections of the Act were patterned after the Interstate Commerce Act. Instead Sections 4 and 5 of the Natural Gas Act provided only that rates and charges of "* * * *any* natural-gas company * * * shall be just and reasonable," which made it comparable to the Interstate Commerce Act prior to the 1920 amendment, 36 Stat. 539, 551 (1910). In further direct contrast to the individualized provisions of the Natural Gas Act, the Civil Aeronautics Act of 1938, 52 Stat. 973, which was enacted contemporaneously,[35] contains a detailed Rule of Rate Making obviously taken from the Interstate Commerce Act and directed to group rate making.[36]

The individualized nature of the Natural Gas Act was also recognized by this Court in *Bowles* v. *Willingham,* 321 U.S. 503 (1944), when it described the statute as one which "Congress has provided for the fixing of rates which are just and reasonable in their application to particular persons and companies," (321 U.S. at 517), and contrasted this to the provisions of the Emergency Price Control Act of 1942, *supra,* providing for group regulation. In addition, the Supreme Court in effect upheld the individual approach to pricing natural gas production when it rejected a

[35] The Natural Gas Act was approved June 21, 1938 while the Civil Aeronautics Act was approved on June 23, 1938.

[36] Originally 49 U.S.C. § 642(e); now 49 U.S.C. § 1482(e).

group ceiling price approach advanced by Justice Jackson in his dissent to *Hope*. In that dissent, Justice Jackson stated that he was prepared to hold that the long line of cases where the Court had upheld individual costs as a basis for regulating gas companies[37] was inappropriate to a natural gas case under the Natural Gas Act and that:

> "Such a holding would leave the Commission to fix the price of gas in the field as one would fix maximum prices of oil or milk or coal, or any other commodity. Such a price is not calculated to produce a fair return on the synthetic value of a rate base of any individual producer, and would not undertake to assure a fair return to any producer. The emphasis would shift from the producer to the product, which would be regulated with an eye to average or typical producing conditions in the field" (320 U.S. at 652).[38]

The majority in *Hope* rejected this method, however, because it was a novel doctrine (320 U.S. at 653) which had no express statutory sanction (320 U.S. at 616).

The Commission seeks to distinguish these clear statements of the individualized nature of regulation under the Natural Gas Act, by contending that they apply to pipeline regulation of a time long before the

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[37] Citing *Newark Natural Gas & Fuel Co.* v. *Newark*, 242 U.S. 405 (1917); *Public Utilities Commission* v. *Landon*, 249 U.S. 236 (1919); *Pennsylvania Gas Co.* v. *Public Service Commission*, 252 U.S. 23 (1920); *United Fuel Gas Co.* v. *Railroad Commission*, 278 U.S. 300 (1929); *United Fuel Gas Co.* v. *Public Service Commission*, 278 U.S. 322 (1929); *Dayton Power & Light Co.* v. *Public Utilities Commission*, 292 U.S. 290 (1934); *Columbus Gas & Fuel Co.* v. *Public Utilities Commission*, 292 U.S. 398 (1934).

[38] *Cf. Statement of General Policy No. 61-1*, 24 FPC 818, 820 (1960); A. IX/42d.

Commission undertook to regulate producers (Comm. Br. 44, fn. 25, 26; 45, fn. 27; A. X/545d-546d). Yet the Commission itself cites the same *Hope* case and pipeline cases of the same vintage in purported support for the breadth of its discretion. It thus appears that the Commission interprets the aspects of *Hope* which are unfavorable to its group regulation as applicable only to pipeline regulation, but the aspects of *Hope* that the Commission feels are favorable to its group regulation are claimed to be of general applicability. The fact is, however, that some six years after it held natural gas producers to be subject to Commission jurisdiction this Court in *Sunray Mid-Continent Oil Company* v. *Federal Power Commission,* 364 U.S. 137 (1960), held that the same sections of the Act govern both producers and pipelines (364 U.S. at 143) and thus rejected the strong dissent which sought to distinguish between the two (364 U.S. at 159). Moreover, although Sun vigorously contends that it is not a public utility, it is nevertheless caught up in the web of a statute which in true utility regulatory fashion has prevented it from ceasing service at the termination of its contracts, *Sun Oil Company* v. *Federal Power Commission,* 364 U.S. 170 (1960). Given this severe limitation on its freedom to withdraw, it is only reasonable that, as this Court has held, a producer be afforded the concomitants of a utility statute,[39] which include consideration of the effect of regulation on the individual and protection against confiscation.

Notwithstanding the clear words of the statute and the cases cited above that support individual regulation under the Natural Gas Act, it does not follow that

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[39] *Atlantic Refining Company* v. *Public Service Commission of New York,* 360 U.S. 378, 389 (1959).

group rate making is impossible under the statute. As will next be discussed, the ICC devised and has long used such a group method. The Commission, however, neither obtained the evidence nor made the findings necessary to such method. Nor is the Commission apparently willing to accept the standards and restrictions on its discretion that such a group method entails. Accordingly it attempted to rationalize its action by wholly unwarranted interpretations of its statutory powers and its constitutional limitations. Sun submits that the Commission should be required to mold its group method to the statute and the Constitution, rather than to mold the statute and the Constitution to its method.

C. The ICC, as Affirmed by This Court, Has Reconciled Group Rate Making With a Statute Providing for Individual Regulation by Requiring Group Evidence That Is Typical and Representative of the Individual and by Further Providing for a Savings Clause Whereby the Individual May Obtain an Exemption If Its Experience Is Not Typical or to Protect Against Confiscation

Prior to being relieved of its obligation to fix rates on an individual basis by the Transportation Act of 1920 (*supra* p. 57), the ICC had nevertheless commenced rate regulation by a group method. The rationale for such group regulation was also applied to the fixing of divisions of revenues among carriers, and was articulated in detail by Justice Brandeis in *Akron, C. & Y. R. Co.* v. *United States,* 261 U.S. 184 (1923), the *New England Divisions Case.* This rationale has been since applied in numerous divisions cases, including a proceeding reviewed and affirmed by this Court in its last term, *Chicago & N. W. R. Co.* v. *Atchison, T. & S. F. R. Co.,* 387 U.S. 326 (1967).

In the *Divisions* case, it had been argued that in fixing divisions carriers must be considered individually rather than in groups. This Court upheld the use of groups, however, and ruled that it need not reach the question of the need for individual regulation because the ICC's order was "based upon evidence which the Commission assumed was typical in character and ample in quantity to justify the finding made in respect to *each* division of *each* rate of *every* carrier" (261 U.S. at 196-7).[40] The Court then analogized to the ICC rate regulation prior to the Transportation Act of 1920 and noted that when changes were applied for in substantially all rates in a large territory, "the Commission made them by a single order; and, in large part, on evidence deemed typical of the whole rate structure" (261 U.S. at 197). This method, which the Court stated resulted from the actual necessities of procedure and administration (261 U.S. at 198), was likened to the creation of a rebuttable presumption, whereby "if the Commission finds that evidence introduced is typical of traffic and operating conditions, and of the joint rates and divisions of the carriers of a group, it may be accepted as *prima facie* evidence bearing upon the proper divisions of each joint rate of every carrier in that group" (261 U.S. at 199).

The rationale of this method of regulation is simple and obvious. If the group evidence is typical and representative of the individuals in the group, and the rates fixed will recover the group cost of service, then the individual's right to a minimum of its operating expenses and capital charges is protected. At the same time the individual's right to protection against

[40] The Court later held that there was support for the ICC's assumption that the evidence was typical (261 U.S. at 203-4).

confiscation is conferred on the group, *Baltimore & Ohio R. Co.* v. *United States,* 298 U.S. 349, 356 (1936). If, however, the Commission fixes rates on the basis of evidence that is not typical, its action is to be reversed, *United States* v. *Abilene and Southern R. Co.* (*The Orient Case*), 265 U.S. 274 (1924); *Atchison, T. & S. F. R. Co.* v. *United States,* 225 F. Supp. 584 (D.C. Colo. 1964).

The threshold question of this group method is the use of typical evidence. Like any factual question, the requirements of cross-examination, rebuttal and findings apply. This group method provides, however, for further inquiry into the subject of typicality in the form of a savings clause. Under such procedure individuals may seek exemption from rates otherwise based on evidence that is typical and representative of the group, because the evidence is not typical and representative of themselves. Thus, the Court in the *Divisions* case, consistent with its characterization of a finding of typicality and representativeness as to the creation of a rebuttable presumption, further held as follows (261 U.S. at 199):

> "* * * As pointed out in Railroad Commission v. Chicago, B. & O. R. Co., 257 U.S. 563, 579 * * * serious injustice to any carrier could be avoided by availing of the saving clause which allows any one to except itself from the order, in whole or in part, on proper showing."

The function of a savings clause, however, is not limited to providing the individual the opportunity to show that the group evidence is not typical as to itself. It further protects the individual against confiscation. Confiscation is fundamentally a company-wide concept, *Baltimore & Ohio Railroad Co.* v. *United*

States, 345 U.S. 146, 150 (1953).[41] Divisions and area rates, in contrast, are predicated on the costs of only a portion of the jurisdictional operation. Accordingly, a reduction in rates might be indicated on the portion of the business involving the divisions or area rates based on costs that are validly typical and representative of that portion of the business. On the over-all operations of the individual company, however, any rate reduction would be confiscatory. For this reason it is necessary, in addition to requiring group evidence that is typical and representative, to allow a procedure by which the individual can show the over-all effect of the divisions or rates ordered on its over-all operations and be exempted from the group determination on the basis of this showing of confiscation.

An additional function of the savings clause is to provide a vehicle for exemption from the group determination in the event later developments require such exemption to protect the individual. Thus the ICC recognized that in any industry the relationship of cost and revenue is ever-changing, and the savings clause is not a static concept related only to a single test year. Instead the individual must be afforded the opportunity to show changed facts and circumstances that merit review of the group determination based on actual operating experience of the particular carrier. To this effect, in *Baltimore & Ohio R. Co.* v. *United States,* 298 U.S. 349 (1936), this Court held that Congress had not limited the time within which a carrier may sue to enjoin enforcement of a rate or division order because "* * * divisions valid when

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[41] Confiscation is also predicated only on the jurisdictional business of the company, *Brooks Scanlon Company* v. *Railroad Commission of Louisiana,* 251 U.S. 396 (1920).

made may later become confiscatory" (298 U.S. at 371).

The validity of the savings clause concept discussed above is well illustrated by this Court's decision last term in *Chicago & N. W. R. Co.* v. *Atchison, T & S. F. R. Co.*, 387 U.S. 326 (1967). In that case the Court noted that individual carriers that were then contending for special treatment had not alleged that group evidence or findings were unrepresentative but that the prescribed divisions would have an unduly harsh impact on them (387 US. at 343). As to this latter claim, however, the Court found that two of the carriers had not shown that the new divisions did not fairly reflect their cost of service (387 U.S. at 362-363). As to the third carrier, the Court found that "* * * it is still not clear, that the new divisions will have the disastrous or unfair effects alleged by the Rio Grande" (387 U.S. at 365). In other words, the carriers had not shown confiscation. Even then, however, the Court recognized that the savings clause would give the complaining carriers continuing opportunity to complain if experience proved that the divisions were so unduly severe as to jeopardize the carriers' ability to provide service (387 U.S. at 366-367).

D. The Commission's So-Called Savings Clause Does Not Perform Any of the Savings Clause Functions and It Is Not Too Early to Determine This and to Require a Proper Provision

In further demonstration of its erroneous view of the law governing group rate making, the Commission looks upon a savings clause, not as a matter of right, but as a matter of grace (Comm. Br. 64). Nevertheless, it has throughout its brief apparently sought to use the savings clause to give the impression that

every problem of the individual and every claim of unfairness that could possibly arise will eventually be resolved by the Commission if only they are separately presented in a savings clause application (Comm. Br. 16, 26, 30, 64, fn. 38, 65, fn. 40, 96, 98, 160, 162, fn. 31, 163). Sun submits that this Court cannot accept the savings clause as a "cure all" for the myriad defects of Opinion No. 468 and the record in this case. Initially Sun contends that not even a proper savings clause can save the Commission from the reversible error of its failure to recognize and apply a proper group rate making method including its failure to base its order on typical and representative evidence in the first instance, *The Orient Case,* 265 U.S. at 291; *Atchison, T. & S. F. R. Co.* v. *United States,* 225 F. Supp. 584 (D.C. Colo. 1964).[42] Furthermore, it is clearly evident that no matter what other inequities will be considered, the Commission's version of a savings clause advisedly will not perform the functions that this Court recognized as appropriate in *Chicago & N. W. R. Co.* v. *Atchison, T. & S. F. R. Co., supra.* p. 65.

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[42] A short summary of this lengthy opinion is contained in the Government's brief in *U.S.* v. *Atchison, T. & S.F.R. Co.,* No. 23, October Term, 1966, p. 60, fn. 44. There it was pointed out that the ICC had been reversed because of "a lack of typical evidence as required by the *New England Divisions Case* and a failure by the * * * [ICC] to consider all of the factors listed in Section 15(6), either for group or individual carriers (225 F. Supp. at 607)." This holding was distinguished from the issues this Court was called on to decide in *Chicago, N.W. & R. Co.* v. *Atchison, T. & S.F. R. Co.,* 387 U.S. 326 (1967), which included the availability of effective savings clause provisions.

1. The Commission's Savings Clause Advisedly Does Not Protect Against Confiscation and This Failure Is Compounded by a Disallowance of Dry Hole Expenses

A fundamental error of the so-called special exemption provision of Opinion No. 468 is that the Opinion affirmatively provides that it will not protect against confiscation. Although much of the discussion of the Commission in the Opinion and the brief is directed toward the proposition that the circumstances that will allow relief have not yet been determined (Comm. Br. 64-67), enough is said to show that the Commission does not consider the constitutional minimum of confiscation an appropriate ground for relief. Thus the Commission refers with specificity to three circumstances under which relief will or will not be appropriate, and each instance displays a determination not to grant relief from confiscation.

First, the Commission states that it "will not permit a back-door approach to individual cost-of-service under the guise of avoiding confiscation" (A. X/551d). Yet, whether the approach be front-door or back-door, we have previously shown that the measure of confiscation is a cost-of-service made up of operating expenses and capital charges, *Federal Power Commission* v. *Natural Gas Pipeline Company of America,* 315 U.S. 575, 607 (1942), quoted *supra,* pp. 50-51, and confiscation is a company-wide concept (*supra,* pp. 63-64), which this Court recognized as an appropriate subject for an individual presentation in a group case, *Chicago & N. W. R. Co.* v. *Atchison, T. & S. F. R. Co., supra,* p. 65. Accordingly, this Commission's categorical statement that it will not allow an individual cost-of-service presentation simply

means that it will not consider, much less grant relief from confiscation.

Second, the Commission's only mention of conditions under which it would grant relief was if out-of-pocket costs could not be recovered on a particular well. Vagueness as to what are out-of-pocket expenses prompted the court of appeals to remand the case for further definition (A. XII/51). A minimum standard of out-of-pocket expenses for a producer would appear to exclude such vital elements of its cost-of-service as return, depreciation, depletion and amortization, exploration and development costs and overheads, and this Court has clearly recognized that a rate that provides only out-of-pocket expenses does not permit the recovery of costs needed to avoid confiscation, *Baltimore & Ohio R. Co.* v. *United States,* 298 U.S. 349, 356 (1936). Again the Commission's criteria for relief is not confiscation.

Third, the Commission errs in arguing that dry hole expenses are not properly costs to be included in a cost-of-service that measures confiscation.[43] To support this proposition the Commission (Comm. Br. 58-59), as did the court of appeals (A. XII/49), cites *Columbus Gas & Fuel Co.* v. *Public Utilities Commission of Ohio,* 292 U.S. 398, 407 (1934). That case, however, does not support the rejection of dry hole expenses. Instead, it holds only that leases held

[43] The exclusion of dry hole expenses from a savings clause presentation was not decided by the Commission in Opinion No. 468, but arose as a *post hoc* argument by its Counsel before the court of appeals in seeking to rationalize the limits of the Commission's purported savings clause. The court of appeals erroneously adopted the argument of Commission Counsel in what amounts to an advisory opinion (A. XII/49).

for future development should not be capitalized until they are about to be used.[44]

The Commission also argues that dry hole expenses need not be recognized because a producer—"unlike a conventional public utility"—has no legal obligation to remain in business by replenishing its gas supply and may drill additional wells entirely at its option (Comm. Br. 59). This argument is without merit. There are definite limitations on the extent of any utility's obligation to construct facilities to serve the public.[45] Yet it certainly cannot be said that facilities devoted to the public use are not protected against confiscation because the utility at its own discretion undertook to expand its service to the public. Neither is it significant that a pipe line must obtain certificate authorization before constructing while a producer does not require authorization to drill additional wells. If a producer were imprudent in its choice of drilling sites and this could be shown in a rate proceeding, there might be reason to eliminate the expense of drilling those particular dry holes. Absent such a showing, however, there is absolutely no basis for eliminating any, much less all, dry hole expense as the Commission proposes. Moreover, this is particularly

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[44] The distinction is readily apparent from the Commission's Uniform System of Accounts for Natural Gas Companies (Pipe Lines), 18 C.F.R. § 201, *et seq.* Account 796 is an expense account entitled "Nonproductive Well Drilling" and includes dry hole expenses. Account 105 is a capital account entitled "Gas Plant Held for Future Use" and includes Account No. 325.1 which is a sub-account entitled "Producing Lands." The *Columbus Gas & Fuel* case refers to a cost corresponding to the latter account.

[45] *I.C.C.* v. *U.S. ex rel. City of Los Angeles,* 280 U.S. 52 (1929); *Panhandle Eastern Pipe Line Company* v. *Federal Power Commission,* 204 F. 2d 675 (3d Cir. 1953); *The Central West Utility Company* v. *Federal Power Commission,* 247 F. 2d 306 (3d Cir. 1957).

the case since the Commission itself held in Opinion No. 468 that "It is beyond dispute that continuing exploration and development of new gas reserves is necessary in the public interest" (A. X/568d), and it is well-recognized that dry hole expenses are a necessary part of that exploration and development, *Forest Oil Corporation* v. *Federal Power Commission,* 263 F. 2d 622, 625 (5th Cir. 1959). Accordingly, dry hole expenses are an unavoidable incident of providing a continuing natural gas supply for ultimate consumers, and it is inconceivable that this valid operating expense could be constitutionally denied, *Lindheimer* v. *Illinois Bell Telephone Company,* 292 U.S. 151, 164 (1934).

2. The Commission's Refusal to Permit Showings of Atypicality and Its Denial of the Opportunityto Make the Individual Savings Clause Presentation During the Course of the Hearing

Another instance where the Commission's actions with regard to a savings clause must be examined rather than its words, is in the case of the savings clause function of permitting the individual an opportunity to show that its experience was not typical of the group. In this regard the Commission held that exceptions would not be permitted because an individual cost of service exceeded the average area costs (Comm. Br. 66). Although we will subsequently urge, and this Court has found, that average costs do not in themselves equate to typical and representative costs, this restriction against a showing that individual costs exceed average costs would seem to be equivalent to the Commission's pronouncement that it will not permit savings clause presentations on the ground that an individual's costs are atypical of the group.

Sun again emphasizes that an individual showing of atypicality would be without relevance in the instant

proceedings until such time as the Commission used typical evidence and made typical findings in the first instance—which it did not. Nevertheless, the Commission's action in refusing to permit any individual showing in the course of the hearings is highly significant from the standpoint that it demonstrates the Commission's unwillingness to permit a proper savings clause presentation, the difference between the Commission's attitude toward group rate making and that of the I.C.C., and the need for a stay of the rates fixed pending a savings clause presentation, as recognized by the court of appeals (A. XII/51).

In direct contrast to the Commission's obsession with avoiding individual presentations, this Court noted in the *Divisions* case that during the hearings "* * * every carrier was, in fact, afforded the opportunity of, introducing any and all evidence it desired" (261 U.S. at 200). Moreover, an issue in *Chicago & N. W. R. Co.* v. *Atchison, T. & S. F. R. Co., supra,* was whether individual carriers had been estopped because they had not claimed relief during the course of the proceedings (387 U.S. at 342-343, 365).[46]

3. The Commission's Moratorium Is Another Example of Its Avoidance of an Effective Savings Clause

The error of the Commission's moratorium on increased rate filings (A. X/660d-669d) will be discussed in more detail by others; however, it should be recog-

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[46] See pages 27-28 of the brief of the I.C.C. in *U.S.* v. *The Atchison T. & S. F. R. Co.*, No. 23, in this Court's October, 1966 Term, as follows: "Commission procedures, of course, permitted individual carriers to demonstrate that the conditions and circumstances surrounding their service were so different from other members of the group that the Commission should make special findings in order to avoid individual injustice flowing from group-based consideration."

nized that the moratorium is a further example of the Commission's failure to provide a savings clause in the sense that such provisions have been instituted by the I.C.C. and recognized by this Court. The savings clause function of providing the individual the opportunity to show changed conditions from those that prevailed at the time of the decision (*supra*, p. 64) is necessary to I.C.C. practice since pursuant to Section 15(2) of the Interstate Commerce Act additional consideration of a matter determined by the Commission may not be had until further Commission order, 49 U.S.C. § 15(2). The filing provisions of Section 4 of the Natural Gas Act, on the other hand, make it possible for a company to file increased rates without special permission, although the filing is subject to dismissal if changed facts and conditions are not shown, *Panhandle Eastern Pipe Line Company* v. *Federal Power Commission*, 236 F. 2d 606 (3d Cir. 1956).

By precluding filings, the moratorium in effect writes the rate changing provision of Section 4 from the statute or at least extends the statutory five-month suspension provision to an indefinite period limited only by the Commission's discretion—up to 2 years 8 months in this particular instance. In addition the moratorium deprives producers of the further element of protection provided by an effective savings clause.

4. The Savings Clause Is an Important Part of the Group Rate Making Method Notwithstanding the Commission's Attempt to Deprecate Its Significance

The Commission argues that the problem of a savings clause is a minor one because the likelihood of the need for protection is small (Comm. Br. 58-64). This is based on the Commission's claims that dry hole expenses are not to be included in a measure of confisca-

tion, and it has been overly generous in allowing a 12 percent rate of return. Hence, the Commission argues that there is little likelihood that the producer could show confiscation. Also the Commission repeats its prior allegation that it need not guarantee profits to "high cost producers."

We have already shown that the Commission is in error with respect to its contention that dry hole expenses may be rejected. Regarding the purported 12 percent rate of return allowance, this issue will be discussed in detail in the brief of the producer group; however, Sun submits that the Commission's generosity is certainly debatable when it is considered that in addition to providing capital charges the 12 percent must also compensate for overcoming quality deductions and processing and gathering costs, as well as revenue deficiencies from contract limitations. As to the need for compensating "high cost producers," the Commission again erroneously seeks to infer that a producer whose costs are higher than others is in some way imprudent or that such producer seeks its costs notwithstanding its contract limitations or the limits of its customers' ability to pay (*supra*, pp. 52-56). There is no evidence to support any of these inferences. Absent such evidence, Sun submits that the constitutional minimum of over-all operating expenses and capital charges is a necessary standard for the savings clause.

5. Review of the Savings Clause Is Not Premature, Particularly in View of the Commission's Rejection of Individual Presentations and the Absence of Stay Provisions Pending the Presentation and Decision

The Commission claims that its savings clause determination is not yet ripe for review since it has not yet specified all conditions under which it would allow relief (Comm. Br. 64-66). This Court in its last term

considered the question of the prematurity of review with respect to administrative regulations of the Commissioner of Food and Drugs, *Abbott Laboratories* v. *Gardner,* 387 U.S. (1967).[47] In those proceedings it was decided that the regulations were ripe for review if the issues were appropriate for judicial determination and if the denial of judicial review at that time would result in hardship.

As previously discussed the Commission has sufficiently fixed the parameters of its savings clause to warrant Court review on the fundamental issue of confiscation and other aspects which do not follow the I.C.C.'s version of a savings clause. Regarding the question of hardship that would result absent review at this time, the Commission has itself amply demonstrated the nature of this hardship. Thus the Commission has been single-minded in its resistance to any individual presentation before reaching its result and categorical in its opposition to the court of appeals' suggestion that it institute a stay of the rates pending any action under a savings clause (Comm. Br. 67-68). The effect is that the producer must lower its rates without having been individually heard and continue operations at the reduced rates until the indefinite future when the Commission on its own gets around to hearing the individual presentation and deciding the case. Under such circumstances a producer could indeed, in the words of this Court in *Hegeman Farms Corp.* v. *Baldwin* (*supra,* pp. 42-43), "bleed to death."

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[47] See also *Toilet Goods Association* v. *Gardner,* 387 U.S. 158, 162 (1967); *Gardner* v. *Toilet Goods Association,* 387 U.S. 167, 170 (1967).

V

THE COMMISSION'S ANALYSIS OF THE LEGALITY OF THE AREA APPROACH IS ERRONEOUS AND IS DEVOID OF REFERENCE TO THE TYPICAL AND REPRESENTATIVE CONCEPT. IT IS ALSO OBVIOUS THAT THE CONCEPT HAS NOT BEEN CONSIDERED OR APPLIED. ON THIS BASIS ALONE THE CASE SHOULD BE REVERSED AND REMANDED

Despite the clear analogy of the *Divisions* case, its approval by this Court and its many years of application in numerous important cases, the Commission's analysis of the legal basis for the area approach in Opinion No. 468 makes absolutely no mention of this case or the typical and representative concept (A. X/541d-552d).[48] Moreover, the Opinion makes no specific finding and only very limited references to the representativeness of data, and data that is considered representative and used in certain components of the study is rejected as unrepresentative in other components. This convincingly demonstrates that the Commission has no objective standards as to whether a data source is representative or not. Also there are absolutely no findings as to the typicality and representativeness of the averages used, a matter which this Court has expressed its concern on a number of occasions.[49]

Even if the basic data and averages were typical and representative, however, the Commission further

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[48] The Commission's brief makes only passing reference to the *Divisions* case in listing examples of group rate making (Comm. Br. 47) and several superficial references respecting the savings clause procedure (Comm. Br. 67, 68).

[49] *United States* v. *Abilene and Southern R. Co. (The Orient Case)*, 265 U.S. 274 (1924); *Northern Pacific R. Co.* v. *Department of Public Works*, 268 U.S. 39 (1925); *Interstate Commerce Commission* v. *Mechling*, 330 U.S. 567 (1947); *United States* v. *Borden Co.*, 370 U.S. 460 (1962).

erred in that the rates fixed are not designed to recover the costs found. Finally, the Commission, although making a pretense at providing a savings clause, erroneously treats such provision as a matter of grace rather than right (Comm. Br. 64), and the Commission's restrictions on the applicability of the provision make it totally ineffectual to protect against the conditions that a savings clause should prevent.

In the latter portion of this brief Sun will show the extent to which the Commission failed to make necesary findings of typicality and representativeness and the extent to which the Commission could not make such findings on the evidence it had available. Also Sun will show that by reason of the Commission's overriding predisposition to avoid any evidence of the experience of individual companies in the record, the Commission effectively precluded cross-examination and rebuttal on the basic data and thus denied due process. Additionally, in order to avoid repetition Sun refers to the joint brief of a number of respondents which discusses in detail the failure of the Commission to fix rates that would recover costs and the error of the rationalizations on this point advanced by the Commission and others.

Notwithstanding these further showings, however, Sun submits that there is ample reason to reverse and remand the Commission's action on the basis of the prior discussion. As has been shown the Commission has erroneously instituted a group method which gives no effect to the individual and its operating expenses and capital charges. Furthermore, the Commission has failed in its attempts to support this method, and has not even considered, much less applied, the typical and representative concept which this Court has recognized as appropriate to reconciling a group method

to constitutional requirements for protecting the individual against confiscation and a statute providing for individual regulation. On this basis alone Sun submits that the proceedings should be reversed and remanded.

By a reversal based on the issues heretofore presented this Court would not be required to review for the first time the issues which the court of appeals declined to consider because it relied on the Commission's expertise with respect to the typicality of data and averages (A. XII/46) and because it considered various procedural due process errors not to be "errors of law" (A. XII/41). Sun fully recognizes that this Court may in its discretion undertake such review, *Chicago & N. W. R. Co.* v. *Atchison, T. & S. F. R. Co., supra* (Comm. Br. 102), and will next discuss those issues. Nevertheless, Sun also submits that if this case were remanded with directions to consider rate making methods that would reconcile individual and group regulation, and the I.C.C. method were adopted by the Commission upon such a remand, the Commission would of necessity have to reconsider the evidence and make clear-cut findings that the method requires. Accordingly, rather than for this Court to be burdened with review of Commission Counsel's *post hoc* rationalizations[50] on the subject of whether the Commission's action by some chance met the requirements of a method the Commission did not purport to follow, the Commission should have the opportunity on remand to address itself to the problem of typicality and representativeness and a proper savings clause in the first instance.

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[50] *NLRB* v. *Metropolitan Life Insurance Co.*, 380 U.S. 438, 444 (1965); *Burlington Truck Lines* v. *United States*, 371 U.S. 156, 168-169 (1962).

PART II

THE COMMISSION DID NOT CORRECTLY APPLY THE LAW OF GROUP RATE MAKING

The Commission's errors in applying the law of group rate making will be first discussed in relation to the Commission's study of the cost of old gas. This study principally consisted of a composite of data taken from responses to the questionnaires sent out early in these proceedings and weighted averages of the composited data. These averages were then found to be the unit cost of old gas. The principal errors in this study are first the fact that neither the basic data used in the study nor the averages developed therefrom are typical and representative of the individuals regulated. Accordingly, the so-called unit costs of gas are inappropriate for fixing rates in accordance with the principles of group rate making set forth in the *Divisions* case.

In addition to the errors of typicality and representativeness there are many due process errors. Hence, Opinion No. 468 does not meet the requirements of Section 19(b) of the Natural Gas Act and Section 7(c) of the Administrative Procedure Act, 5 U.S.C. § 1006(c), that the action must be supported by reliable, probative and substantial evidence.[51] The basic questionnaire re-

[51] Sun will principally direct its attention to the absence of reliability and probity of the evidence used. There are also many allegations of error dealing with the lack of substantial evidence in these proceedings, and the Commission devotes a material part of its brief to a complex exposition on these subjects (Comm. Br. 112-140). Such complexity apparently prompted the court of appeals to forego review of these issues (A. XII/41) in what Sun contends amounted to an affirmance of the Commission by default. Sun respectfully submits that the issues it urges are separable from the complex substantial evidence issues, and there is ample reason to reverse the Commission without reaching the latter.

sponses were neither submitted for the record nor supported by witnesses who could be cross-examined thereon, even when it became increasingly evident during the course of the proceedings that the data that had been submitted was inconsistent and incompatible for compositing. Also evidence that would have challenged the validity of costs attributed to individual producers was not allowed in the record. In fact the identity of individual producers was excluded from the exhibits showing the costs attributed to each producer and the composite results of those costs. Instead the companies were identified only by a code number and efforts to identify the companies on the record and to dispute the costs were forestalled by the Presiding Examiner.

The errors in the case of the new gas cost study included both the lack of representativeness and due process. In addition the study illustrates the absence of Commission evidentiary standards. These errors were introduced into the study in part by use of the questionnaire responses, but were compounded by the use made of such data in the new gas study and further compounded by the use of other data sources of limited or unknown representativeness and most uncertain reliability.

I

THE ERRORS OF THE OLD GAS STUDY

A. The Lack of Representativeness of the Questionnaire and Responses to It

The Commission's failure to obtain a representative coverage of producers in the Permian Basin can only be fully appreciated in context with the Commission's originally announced intention to set a price for the gas itself from whatever source questioned,[52] and its re-

[52] *Statement of General Policy No. 61-1*, 24 FPC 818, 820 (1960).

jection of requests by small producers that they be relieved of requirements that they file questionnaire responses (A. Supp./18s). This rejection of the small producer requests for relief from responding to the questionnaire was because the Commission was uncertain whether a sample of producer costs would be representative. Therefore, it held that it would be desirable to have cost data with respect to "all producers in the area" (A. IX/40d). At the hearings, however, it soon became apparent that the Commission had been far from successful in obtaining cost data from "all producers in the area." Also the Commission had been far less than diligent in obtaining that objective.

1. The Data Sought, Obtained and Composited Was Wholly Inadequate as Was Also the Commission's Effort to Obtain More Complete Data

The extent of the Commission's failure to obtain cost data of all producers was revealed when a Commission Staff witness sought to testify that the costs used by Staff in its composite were sufficiently accurate for the purpose of the proceeding, and on cross-examination it was shown that he was unaware of the number of producers in the area, the number of questionnaires sent out, or the number of answers received (A. IV/1356, 1362-1363). As a consequence, the Presiding Examiner directed that the Staff respond with statistical and other information on the coverage of its data (A. IV/1377-1378). The response to the Examiner was in the form of a memorandum (A. IX/74d-81d), and principally from this memorandum pertinent data on the unrepresentativeness of the questionnaire responses may be ascertained.

There were at least 2610 gas producers in the Permian Basin area who sold gas in 1960 under percentage

type contracts, and of these, 351 had rate schedules on file (A. IX/79d); 365 producers were named respondents in the December 23, 1960 order initiating the proceedings, and appendix questionnaires were sent to 458 companies (A. IX/75d). The following table shows the responses received and tabulated (A. IX/75d-76d):

Appendix	Responses Received	Responses Included In Staff Exhibits	Companies[53] Included In Staff Exhibits
A	249	220	298
B	68	67	67
C	105	69	107
Total Responding with Cost Data[54]	173	136	174

The limited coverage of the basic evidence as shown above is further apparent from other statistics in the record. Thus a Commission staff tabulation made up of 198 of the Appendix A responses showed that those companies drilled but 52% of net wells drilled in the Permian Basin (A. II/732; III/938-939, 949).

Despite the Commission's burden of proof in these proceedings[55] and its broad powers to investigate, to require the production of witnesses and documents and

[53] Some responses referred to one or more companies.

[54] Summation of Appendices B and C since Appendix A did not inquire as to cost data.

[55] Rate reductions were ordered under Section 5(a) of the Natural Gas Act wherein the Commission has the burden of proof, *Sunray Mid-Continent Oil Company* v. *Federal Power Commission*, 364 U.S. 137, 144 (1960).

to have its orders enforced,[56] the Commission made no use of these powers. Moreover, its efforts otherwise to obtain a more complete response were minimal. Thus as to the 64 companies which did not respond to the original rate schedule questionnaire, no effort was made to obtain data other than a single follow-up letter (A. IV/1150-1151). Similarly, a follow-up letter was the only effort to obtain data from 16 companies which filed incomplete responses (A. III/1069-1070), and apparently no effort whatsoever was made to obtain any explanation with respect to the 12 questionnaires which were returned blank (A. III/1068).

2. The Commission Compounded the Problem by Excluding the Appendix C Responses

Based on statistics such as shown above there was expert testimony that the Appendix data used was biased and unrepresentative, principally because of the dearth of evidence of small producer costs (A. IV/1299-1304; V/1624-1625). Also the Presiding Examiner made findings to this effect (A. IX/308d-310d). The Commission, however, used the appendix data and purported to achieve representativeness by eliminating the costs of the 107 small producers who filed responses to the Appendix C questionnaire (A. X/629d-630d).

There is no evidence in the record to support the Commission's conclusion that it could achieve representativeness by eliminating the costs of Appendix C producers. The lack of representativeness as testified to by witnesses and found by the Examiner resulted from a dearth of evidence from small producers. It

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[56] Sections 5, 6, 8, 9, 10, 14, 15, 16 and 20 of the Natural Gas Act, 15 U.S.C. §§ 717d, 717e, 717g, 717h, 717i, 717m, 717n, 717o, 717s.

is therefore incomprehensible how a more representative coverage would result by disregarding the costs of the limited number of small producers who did respond to the Appendix C questionnaires.

The Commission's unstated theory is apparently that it used a complete sample of large producers and other costs are immaterial. The sample it used is not exclusively a large producer sample, however, since 25 small producers are included among the Appendix B producers.[57] Moreover, the result of the Commission's action is that rates for both large and small producers are being fixed on the costs of an arbitrary and self-selected group whose costs do not represent the large producers, the small producers, the entire group of large and small producers, or even the Appendix B producers whose purported costs were averaged.[58]

Both the Presiding Examiner and the Commission rejected a producer study, the Joint Association Survey (JAS), as being a nonrandom sample in which there was considerable self-selection and an overstatement of large company characteristics and an understatement of small company characteristics (A. IX/27d; X/591d-592d). Yet, it is difficult to find a more apt description for the Appendix B data which formed the entire basis of the old gas study.

The Commission brief attempts in a footnote (Comm. Br. 108, fn. 82) to pass off the Commission's

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[57] Small producers had the option of filing Appendix B or Appendix C.

[58] As will be later discussed in more detail, this Court has recognized that the weighted average of a group selected on an arbitrary basis is unlikely to result in a cost that is representative of the group, *United States* v. *Borden Co.*, 370 U.S. 460, 468-469 (1962).

failure to obtain complete or representative responses with generalizations purporting to show it is unlikely that the presence of more representative data would change the result. Generalizations on costs are not entitled to weight, as this Court has held, *Baltimore & Ohio R. Co.* v. *United States,* 298 U.S. 349, 379 (1936), and this certainly should be the case here where contrary to the doubtful generalizations in the Commission's brief [59] there is positive evidence, including testimony by a Commission Staff witness, that based on studies made small producers are likely to have higher costs (A. IV/1149; 1298-1299). Also the record shows that by the very nature of weighted averages the inclusion of small but higher cost producers can have material effect on the result.[60] Finally, there is to be considered the fact that the Commission itself recognized that small producer sales could have a material effect on the over-all cost of gas to pipelines when it affirmed the Examiner's rejection of the JAS.

3. The Commission Further Compounded the Problem of Representativeness of Data by Excluding Costs of Casinghead and Combination Lease Gas

In addition to compounding the problem of representativeness of the data by eliminating the costs of

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[59] *E.g.*, the small producer whose testimony is cited in the Commission brief to the effect that in his experience the unit costs of small producers were no higher than those of larger producers (A. V/1656-1658) admitted in his remarks that he had access to no producer's figures other than his own (A. V/1657).

[60] The inclusion of nine small but high-cost producers in Staff's array had over 40 times the effect on the weighted average cost of gas well gas as did the inclusion of a very large lower cost company producing 6.4 times the volumes. Also, the inclusion of these few small but high-cost producers raised the weighted average cost over ½ cent per Mcf (A. IV/1151-1162).

the Appendix C producers, the Commission further reduced the representativeness of its cost data when it eliminated the cost of casinghead gas and gas-well gas produced from combination leases and fixed the rate from these products on the purported cost of non-associated gas-well gas. As a result of the Commission's various eliminations of data plus its failure to obtain adequate data in the first instance, the Commission used costs from only about 15 percent of production and from only 40 out of over 2600 producers to fix rates for all production in the Permian Basin.[61]

The Commission's rationale for using gas-well gas costs to fix the price of casinghead gas and gas-well gas from combination leases is that the Commission was thereby fixing a price based on the value of the product as a commodity. The only case cited in support for this method of rate fixing was *Air Freight Investigation,* 9 CAB 340 (1948) (Comm. Br., 156, fn. 26). In that case, however, the CAB was fixing a minimum price and, hence, the problem was entirely different constitutionally from reducing rates to a specific level such as the Commission is undertaking here, *Hegeman Farms Corp.* v. *Baldwin, supra,* pp. 42-43. In further contrast to the Commission's approach, the ICC recognized that it could not fix divisions for one commodity based on the costs of others, *New England Divisions,* 66 ICC 196, 200-201 (1922). Moreover, Judge Prettyman, in *Mississippi River Fuel*

[61] These statistics on the actual percentage of costs found are to be compared with the Commission's cleverly-worded comment that it obtained costs from the books and records of producers who account for 75 percent of all gas produced in the Permian Basin and 85 percent of all gas well gas (Comm. Br. 107).

Corp. v. *Federal Power Commission,* 163 F. 2d 433 (D.C. Cir. 1947) held as follows:

> "* * * Our law has never provided that either a company, a commission, or a court can fix a price for a utility commodity or service by an abstract observation or by a comparative evaluation of current prices for other commodities or services, or by any such process" (163 F. 2d at 450).

The Commission also seeks to support its fixing of rates on costs from such a minor proportion of production by the claim that the allowance is larger than it would have been if the Commission had found the cost of casinghead gas and gas-well-gas from combination leases. In reaching this conclusion, in Opinion No. 468, however, the Commission summarily rejected the inclusion of any allocated cost of processing the gas to remove liquid hydrocarbons (A. X/623d-624d). This summary rejection of processing costs was notwithstanding a contrary conclusion reached in the *Phillips* rate case, after extensive findings by both the Examiner and the Commission, 24 FPC at 562-565, 679-683.[62]

In its brief the Commission further suggests that the costs of casinghead and residue gas are less than gas-well gas even giving effect to processing—if the Commission had reduced by 1.09 cents per Mcf the processing costs urged by its Staff in hearing.[63] On this

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[62] The rejection of processing costs is also diametrically opposed to the treatment of the same item in the new gas study. There the Commission reduces the cost of service with a net liquid credit which is predicated on the theory that gas should bear all the costs of processing (A. X/586d-587d). The treatment in the old gas cost study, however, is predicated on liquids bearing all processing costs.

[63] The reduction was achieved by changing an arbitrary allocation factor from 1 to 1 to 2 to 1 (Comm. Br. 159).

basis the Commission concludes that, "* * * although residue gas costs are too imprecise to serve as the basis for pricing this type of gas on a cost basis, the adjusted staff study confirms the Commission's general conclusion that residue-gas costs do not exceed the price fixed for gas-well gas * * *" (Comm. Br. 159). It is submitted that the Commission's brief walks too fine a line. If residue gas costs are too imprecise to serve as the basis for pricing, they should not be arbitrarily reduced in the brief by changing an allocation factor and then be used to support a conclusion that was obviously "already arrived at."[64] The fact is that the Commission is under no duty—statutory or otherwise—to reduce producer rates, and if the evidence is not available for the Commission to bear its burden of proof for reducing the rates under Section 5(a) of the Act, Sun submits that the Commission has no alternative but to dismiss its investigation.

B. There Are Many Due Process Errors in the Proceedings

Largely as a result of the Commission's determination that individual costs would not enter into its consideration, the Commission, its Staff and the Presiding Examiner consistently and vigorously resisted efforts by parties to probe beyond certain fixed limits in the proceedings. The imposition of these limits precluded the following: submittal of the questionnaire responses in evidence, cross-examination of witnesses who prepared the responses, identification of individual companies shown on summary exhibits arraying

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[64] It will be recalled that one of the Commission's principal reasons for going to a group method was that allocation methods were a means of supporting a result already arrived at, *Phillips Petroleum Company*, 24 FPC 537, 544 (1960).

the costs attributed to each company, and cross-examination and submission of rebuttal evidence to dispute the costs attributed to particular companies,[65] Sun submits that all of these limitations constituted denials of due process. Moreover, they are decidedly material denials of due process since there is clear evidence in the record of inconsistencies in reporting the basic data that would preclude compositing such data. In addition, Sun sought to have the record reopened to introduce even more such evidence of inconsistencies, but was denied this opportunity.

1. The Examiner and the Commission Pursued a Deliberate Policy of Restricting Cross-Examination and Rebuttal on Very Material Matters

Restrictions on cross-examination of the basic data were prescribed by the Presiding Examiner after the Staff's composites of that data were submitted for the record. In response to an inquiry which clearly set forth the due process problems inherent in refusing cross-examination of witnesses who prepared basic data, the Presiding Examiner responded by directing that inquiry would be permitted of the Staff which would, in turn, seek the answers from the producers. Even then the Examiner limited the scope of this second-hand examination by stating that the requests should not be too extensive (A. III/759-761).

Inquiry during the course of hearing revealed the impossibility of such derivative cross-examination. Although anomalies appeared on the face of the re-

[65] Another aspect of the Commission's denial of due process was discussed in relation to the Commission's refusal to permit savings clause presentations during the course of the proceedings or to stay its determination until the savings clause presentation could be heard.

sponses,[66] the responses are reports predicated on the books and records of the company and hence the problems are often not readily apparent from the report. For example, although the presence of condensate under wells classified as having no lease separation indicated a particular error in classifying leases (fn. 66), other similar errors in lease classification would not appear on the face of the reports. Rather they would require a further probing of the books, or at least the opportunity to examine personnel who were familiar with the books.

It is obvious that the Staff witnesses who composited the questionnaire responses did not examine the books for compatibility; nor were they capable of responding on these matters even though they recognized that differences inhere in the keeping of producer books. Thus, the Staff witness in charge of compositing the basic unallocated costs (A. III/781) admitted that the Commission found through past field examinations that widespread differences did in fact exist among the various companies reporting, with regard to their treatment of many items of similar nature (A. III/-

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[66] One such important anomaly was in the case of the item of lease classification which controlled whether costs were to be assigned to the gas-well, casinghead, combination, or some other classification. The Commission instructions directed that the classifications be in accord with state regulatory body definitions, but Texas does not classify wells in the Commission's categories, and the Commission Staff was in no position to check on the company classifications. It therefore had to rely on the untested judgment of the companies for classification (A. III/1087-1088). As admitted by a staff witness the presence of error in classification or reporting was shown by figures depicting condensate production for wells classified as "Gas-condensate without lease separation facilities" (A. IV/1521-1523).

785).[67] Also the same witness testified that instructions given companies responding to the Staff questionnaires permitted inconsistency even in such important matters as whether a given item might be capitalized or expensed (A. III/1046-1048).

Recognizing the inconsistencies inherent in the various accounting approaches of the reporting companies which would carry through in their responses to the questionnaires, the Staff witness sought to minimize the effect of these admissions by contending that Staff had conducted limited field examinations and "test checks" on the responses (A. III/783) and that he had utilized his experience in the review of individual cases to conclude that the inconsistencies were not of great magnitude (A. III/1047-1048). The field examinations and test checks were admitted to be "of a cursory nature and limited in scope," however (A. III/783),[68] and the only experience that the witness specifically cited was in connection with Sun Oil Company and Pure Oil Company. Even then it was shown on further examination that the witness had not taken part in the general rate proceeding of either company,

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[67] This inconsistency in accounting is well known by the companies through years of past experience and discussion in joint producing ventures. See also Brock, *Petroleum Accounting,* The Journal of Accountancy, December 1956, p. 53.

[68] *Cf., Tagg Bros. & Moorehead* v. *United States,* 280 U.S. 420, 432 (1929); *Acker* v. *United States,* 12 F. Supp. 776, 778 (D.C. N.D. Ill. 1935) affirmed 298 U.S. 426 (1936). In regulating market agencies, which does not have the same constitutional limits as does producer regulation (*supra,* p. 46), the Secretary of Agriculture nevertheless preceded the fixing of rates by specially auditing the books of the firms regulated.

and their procedures were not within his personal knowledge (A. III/1048).[69]

The limitation on examination into evidence pertaining to individual companies also extended beyond the basic data to the ultimate results. Thus the Commission staff after performing various allocations and calculations in working papers which were not submitted for the record finally devised Exhibit No. 174 in which costs attributed to each company were listed (A. VII/493e).[70] The names of individual companies were omitted from the exhibit, however,[71] and hence the attributed costs could not be traced through on the record to exhibits showing the data composites, to say nothing of the questionnaire responses which were not in the record. Moreover, efforts to identify Sun as one of the individual companies on the arrays and to rebut the propriety of costs attributed to Sun with a prior inconsistent Staff presentation in another case were vigorously resisted by the Staff and rejected by the Presiding Examiner (A. IV/1145-1149; 1166-1170).[72]

As the anomalies in that basic data became apparent along with evidence of the minimal effort of Staff to

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[69] The testimony of other Staff witnesses further demonstrates the limited extent of examination of company records in making the "test checks" (A. III/1082-1084, 1088-1089), as well as the extent to which the Staff did not go behind the data submitted even when reason to do so was indicated (A. III/1105; IV/1522).

[70] These listings of individual company costs were termed "arrays."

[71] The line number of the data on each company in effect became the code for identifying the companies; however, the key to this code was not revealed on the record.

[72] Sun's individual presentation which the Examiner rejected in evidence (A. III/1080-1081; V/1905-1907), would also have served as rebuttal to the costs attributed to Sun in the array.

examine company records, Sun moved that the Commission Staff presentation be stricken. No answers were filed and no rulings were made as to this motion or to a later renewal of it.

Subsequently, after the close of the evidentiary hearing but before the issuance of the Examiner's decision, Sun again renewed its motion to strike, this time as part of a motion to reopen the proceedings to admit still further evidence of anomalies and inconsistencies in the basic data (A. Supp/20s-34s).[73] As to this motion the Commission Staff finally responded (A. IX/-87d) and the Examiner ruled, denying the motion (A. Supp/35s).[74] Sun appealed to the Commission in its exceptions to the Examiner's decision; however, the Commission made no ruling on Sun's various motions to strike, and the Staff's cost presentation was adopted with mention only that the questionnaires were designed to fill an information gap caused by the absence of a uniform system of accounts for producers (A. X/577d).

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[73] The new evidence consisted of a survey of producers who responded to the same questionnaire in the Commission's subsequent area rate proceedings, Docket No. AR61-2. Forty-three of those surveyed were respondents herein, and the survey showed substantial differences among producers in their interpretation of what information had been required by the Commission in such important categories as depreciation, gas volumes and lease classification.

[74] The Examiner ruled that the validity of Sun's motion could be evaluated on the evidence of record (A. Supp/36s), an apparent reference to his intention to reject the Staff's presentation. Since the Examiner had otherwise extensively used data from the questionnaire responses, Sun took exceptions to this aspect of his use of the data.

2. The Commission's Denial of the Opportunity To Cross-Examine or Rebut the Basic Data and the Arrays Was Clear and Reversible Error

The Commission's failure to rule on the many evidentiary errors pointed out by Sun was clearly contrary to Section 8(b) of the Administrative Procedure Act, 5 U.S.C. § 1007(b), which provides that, "The record shall show the ruling upon each such finding, conclusion, or exception presented." Furthermore, this Court has many times ruled against the use of raw report data, such as the questionnaire responses which had been used without providing opportunity to cross-examine or rebut that data or the results derived therefrom.

Even assuming that the Commission has by its questionnaires been able to bridge the gap between the individual company accounting systems and a uniform system of accounts—a fact which is seriously doubted —it by no means follows that the reports filed in response to those questionnaires are capable of being used without allowing cross-examination and rebuttal. This Court has clearly rejected the practice of fixing rates by use of data obtained from annual report forms which were not placed in the record, *United States* v. *Abilene and Southern R. Co.*, 265 U.S. 274, 287-289 (1924);[75] *Northern Pacific R. Co.* v. *Department of Public Works*, 268 U.S. 39, 43 (1925); *West Ohio Gas Company* v. *Public Utilities Commission of Ohio*, 294 U.S. 63, 70 (1935). The reason for this is evident from even a cursory review of the nature of a rate proceeding. Rates are not fixed on costs taken directly from books of account, but only on those figures as they reflect anticipated company operations and other eco-

[75] This case was a group proceeding for the fixing of divisions.

nomic factors. Thus, test year book figures often are adjusted for known changes, *Panhandle Eastern Pipe Line Company,* 25 FPC 787, 795 (1961), and cases cited therein; *Panhandle Eastern Pipe Line Company,* 13 FPC 53, 102 (1954), reversed on other grounds, *City of Detroit, Michigan* v. *Federal Power Commission, supra.* Also depreciation may be adjusted from what is reflected in company books and annual reports, *Panhandle Eastern Pipe Line Company,* 13 FPC at 87-93. Indeed the Commission has instituted a rate investigation based on annual report data, only to dismiss the proceeding, without hearing, when the company was given the opportunity to submit a more detailed explanation of data in the report, *Colorado Interstate Gas Company,* 31 FPC 434 (1964).[76]

In addition to the need to cross-examine and rebut report data to assure its propriety for ratemaking purposes, the compositing of data in a group proceeding compounds the problem of using untested report data. Even when books and records of a company have for many years been kept in accordance with a uniform system of accounts, there is no guarantee that there will be uniformity,[77] and serious disputes arise as to proper accounting entries.[78] As previously discussed,

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[76] Many similar instances occur informally as part of the Commission's continuing surveillance of pipeline rates, but do not reach the point of being reflected in the Commission reports, FPC 1965 Annual Report, p. 137.

[77] Corey, *Problems in Uniform Accounting,* Public Utilities Fortnightly, January 19, 1967, pp. 23, 24-26.

[78] By order of June 19, 1967 the Commission issued an Order to Show Cause to Tennessee Gas Pipeline Company, a company that has been subject to Commission jurisdiction for over 20 years, respecting a number of accounting entries, including entries dealing with gas production properties, *Tennessee Gas Pipeline Company,* Docket No. RP67-22.

this record shows that producers are known to maintain differing accounting systems and the questionnaires allowed important inconsistencies in the responses.

The Examiner's program for avoiding cross-examination on the basic data and the ultimate costs shown in the arrays, as well as his plan for cross-examination using Staff witnesses as middlemen, closely parallels the circumstances of *Powhatan Mining Co.* v. *Ickes,* 118 F. 2d 105 (6th Cir. 1951). There, in a hearing before the Director of the Bituminous Coal Division of the Department of Interior, the Director admitted in evidence tabulations of coal prices coded as to the particular companies involved, but refused to identify the companies on the code. The reason given for maintaining secrecy was that disclosure was contrary to the statute. Of course, no such reason is available here.

Although the Director in *Powhatan,* in similar fashion to the Examiner here, made various attempts to divert the parties from a full cross-examination of the basic data, such methods were held to be inadequate. Thus, the Director indicated a willingness to permit inquiry into particular sales and to allow any party to subpoena the seller. The court, however, summarily reversed the Director's action in not identifying the sellers and permitting cross-examination on the basic data underlying the tabulations, noting that "when the Division introduces the tabulations, * * * petitioners should be given the opportunity to cross examine as to the weight and authenticity of the figures" (118 F. 2d at 109), see also *Wirtz* v. *Baldor Electric Company,* 337 F. 2d 518, 526 (D.C. Cir. 1963).

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3. The Commission's Brief Attempts To Defend the Due Process Errors Largely by Misinterpreting Sun's Arguments and Expanding the Commission's Holdings by Post Hoc Rationalizations

The Commission brief seeks to distinguish the *Powhatan* and *Wirtz* cases on the ground that in the instant proceedings the names of the respondents and responses were fully disclosed in the public files, and there was ample opportunity to test the probative value of the data submitted. In view of the Commission precedures discussed above we dispute that there was public indentification of the producers listed on the arrays and that opportunity was provided to test the probity of the data submitted. In any event, the Commission reference to disclosure of the identity and data in public files is immaterial. The significant fact is that it was not included in the record of this case and that it could not be cross-examined or rebutted. It is, of course, a normal practice for annual reports to be available in public files. Yet as previously noted this Court has held that such material cannot be used to fix rates without being introduced into the record.

The Commission also infers that Sun bases its position on the absence of a uniform system of accounts for producers (Comm. Br. 109-111).[79] Such argument is erroneous. Sun's opposition to the Commission's procedure for precluding cross-examination and re-

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[79] The Commission apparently interprets Sun's position in this fashion so that it can then point out that Sun opposed the creation of a uniform system of accounts (Comm. Br. 110, fn. 86). Sun's opposition, however, was at a time when the Commission had not yet decided on its method of group rate making. Hence Sun considered the creation of such an accounting system premature. It should also be noted that even if a uniform system had been instituted at that time, it would have not been available for these proceedings.

buttal of the reports used for basic data and the arrays would be equally applicable if there had been a uniform system of accounts, although the inconsistencies in the basic data and the error in using such data for compositing are no doubt exacerbated by the absence of a uniform accounting system.[80]

The Commission also urges that Sun's contention of unreliability in the use of diverse accounting systems was "throughly considered" and the short answer to Sun's position is provided by a statement by one of the Commissioners prior to the evidentiary hearing that it would be difficult to assemble evidence in the proceeding and attention must be given to weight and materiality rather than refinements (Comm. Br. 110). Beside the fact discussed above that the diversity in producer accounting systems is not in itself controlling in Sun's due process arguments, the Commission's brief is highly misleading in its citations to support the contention that Sun's argument was "thoroughly considered." The citations are to arguments in pleadings by Commission Staff Counsel and a statement by a Commission Staff witness—not to holdings of the Commission, as Sun believes the statement would in-

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[80] It should be noted that the ICC has a uniform system of accounts for carriers under its jurisdiction. Also, the ICC's division proceedings are often brought at the behest of the carriers. Hence, the individual carriers must reconcile their evidence in their direct presentation. On the other hand, the Commission here is acting to reduce rates under an investigation. Also it presumably is fixing standards for further proceedings, *Hill* v. *Federal Power Commission*, 335 F. 2d 355 (5th Cir. 1964). Accordingly, it has the burden of proof and must obtain adequate and proper evidence to satisfy that burden.

fer.[81] Moreover, the brief's reference to a Commissioner's statement which was made in a speech to a trade association prior to the hearing, is truly amazing. It is unclear whether the brief is claiming that the Commissioner was stating a prejudgment that no issue involving the gathering of evidence could have weight or materiality, or that the Commission through this one Commissioner's speech prior to hearing was deferring to its Staff on questions of weight and materiality. In any event, Sun submits that the issues Staff Counsel was discussing and indeed none of the due process issues set forth above were considered or ruled on by the Commission; that such issues have both weight and materiality, and in themselves these issues provide ample reversible error.

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[81] Staff Counsel's pleadings principally discussed the further discrepancies among reporting companies which Sun sought to show in a reopened record. One of these discrepancies alone could have required a material change in the result. Thus, the Commission Staff had eliminated all costs of Hunt Oil Company from its compo[illegible]es because it had reported sales and not produced volumes (A. III/783). Yet the survey Sun sought to introduce showed that 16 of 41 producers in these proceedings had also reported sales volumes (A. Supp/22s-23s). This brings up alternative questions of (1) whether the costs of these 16 should also be discarded; (2) whether allowance could be made for the differences in reporting and if so whether: (a) its effect should be shown in both allocations and in the unit cost of gas or (b) its effect should be shown only in the unit cost of gas; (3) whether the inconsistency in volumes should be ignored and Hunt's costs should be included. Despite its so-called thorough consideration, the Commission Staff considered only item 2 (b) of the above (A. X/489d). On this basis Staff Counsel argued that producers would not be benefitted and the inconsistency was immaterial and did not support Sun's requested reopening.

The Commission's brief now considers alternative (3) and concludes that the effect would be immaterial (Comm. Br. 109, fn. 85).

C. The Weighted Averages Also Are Not Typical and Representative

In addition to using unrepresentative basic data in the first instance, and variously denying due process in the use of that data and other aspects of the proceeding, the Commission in Opinion No. 468 further errs by ultimately determining costs on the basis of weighted averages which are not typical and representative. In this regard the Opinion makes absolutely no findings and in no way discusses the typicality and representativeness of its averages, notwithstanding past Commission experience with the erroneous use of averages[82] and the serious attention this Court has given to the question.

1. This Court Has Clearly Recognized That Averages Must Be Typical and Representative Absent Consideration of Individual Conditions, Which Was Not Permitted in This Case

In the *Orient* case, *United States* v. *Abilene and Southern R. Co.*, 265 U.S. 274 (1924), this Court recognized that in fixing divisions, weighted averages are not in themselves typical. Thus, Justice Brandeis, speaking for the Court, held that "averages are apt to be misleading," and they cannot be properly accepted "* * * as a substitute for typical evidence * * *" (265 U.S. at 291). Also in *Northern Pacific R. Co.* v. *Department of Public Works*, 268 U.S. 39, 43 (1925), it was held that fixing rates by a composite figure of

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[82] The Commission has been previously reversed for use of system-wide averages of consumer saturations "without a satisfactory explanation of the circumstances which were thought to require or justify it," *Michigan Consolidated Gas Co.* v. *Federal Power Commission*, 283 F. 2d 204, 219 (1960); *cert. den.*, 364 U.S. 913. Also, the Commission itself recognized prior to Opinion No. 468 that the use of unsifted averages is error, *Area Rate Proceeding, Docket No. AR61-2*, 32 FPC 97, 98 (1964).

weighted averages developed from published reports and exhibits without considering differences in individual operation was "clearly erroneous."[83] In *Beaumont, S. L. & W. R. Co.* v. *United States*, 282 U.S. 74 (1930), the use of averages was affirmed on the basis that operating and other conditions were shown as to each carrier, and it was not shown that the order would require any service to operate at less than cost (282 U.S. at 87). Here, of course, the Commission made every effort to avoid showings of individual conditions and costs. Nevertheless, it can be shown from the arrays alone that a substantial number of the producers thereon will be forced to operate below costs.

The rationale for requiring more than weighted averages to produce typical and representative results is clearly revealed by this Court's determination in *United States* v. *Borden Co.*, 370 U.S. 460 (1962). In that case milk marketers were attempting to justify price differentials between independent grocers and chain groceries by comparing average costs of serving each classification. This Court held, however, that the milk marketers erred in using averages of classifications of customers that had been arbitrarily chosen and that averages were proper only if the averages produced results that were representative of the group. Furthermore, the Court held (370 U.S. at 468-469) that such rationale was an integral part of using groups in justifying differentials and that differentials could be justified on a group rather than individual basis because:

> "* * * A balance is struck by the use of classes for cost justification which are composed of mem-

[83] The Court also decried the use of "unsifted averages" in *Interstate Commerce Commission* v. *Mechling*, 330 U.S. 567, 583 (1947).

bers of such selfsameness as to make the averaging of the cost of dealing with the group a valid and reasonable indicium of the cost of dealing with any specific group member. High on the list of 'musts' in the use of the average cost of customer groupings under the proviso of § 2(a) is a close resemblance of the individual members of each group on the essential point or points which determine the costs considered" (370 U.S. at 469, footnote omitted).

2. The Commission's Averages Are Not Typical and Representative

It is readily apparent that the Commission in Opinion No. 468 did not in any way seek to justify its group rates by a showing that it used a grouping capable of producing typical and representative results in any sense of the word. As previously noted the choice of the Permian Basin as the basis for a pricing group was because it was well known and convenient rather than because of similarity of its costs (*supra,* p. 8). Moreover, the Commission would permit no review of its choice of the area (*supra,* pp. 10-11) and in no way justified it as a proper economic unit. Furthermore, the use of average costs of Appendix B producers to fix prices for producers not in Appendix B and to fix prices for types of gas for which costs were not determined, certainly cannot be justified on the ground that average costs of the group used bears "a close resemblance to the individual members for each group on the essential point or points which determine the costs consdered." Finally, the weighted average of costs that was determined was not even representative of the Appendix B producers from which it was derived.

Included in Staff's presentation is Exhibit No. 174 which is an array listing the unit cost of production

excluding regulatory expenses and production taxes for 59 of the 67 Appendix B responses Staff claimed to have used (A. VII/493e). Also shown are the unit costs for various elements of production. Adding to each of the arrayed costs shown on Exhibit No. 174, a figure of 1.1 cents per Mcf for the combined regulatory expense (0.14106 cents) and production taxes (0.9375 cents) (A. VII/540e) not included in the exhibit, the unit cost of gas-well gas ranges from $0.04 to $1.72 per Mcf (A. VII/501e-502e).[84]

It should be apparent even to the observer without technical training that an array which is admittedly so widely dispersed (A. X/548d) could not produce a usable average. In the first place, simple arithmetic shows that an average of widely dispersed numbers can in no sense be termed typical of the group. The weighted average of two equal quantities with respective values of 2 and 1000 is 501, but 501 is by no means typical of either the numbers averaged.

In addition, where costs are so widely dispersed, an average cost will always leave a number of producers well below the average and a number with costs markedly in excess of the average. The Commission's lack of concern for producers whose costs substantially differ from the average (A. X/548d, 658d), is clear proof that the Commission was not averaging costs to obtain results that are typical and representative of those in the group, but only as a mathematical device to derive a single number from many numbers.

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[84] Sun refers to these arrayed costs as an indication of the dispersion in costs, and does not thereby admit that these figures are a proper cost determination. It should also be noted that these costs were determined using a 9.5% rate of return recommended by the Staff and not the 12% rate of return adopted by the Commission.

The above obvious impressions were confirmed on the basis of mathematical and statistical concepts by John D. Rice, a professional mathematician with broad experience both as a mathematics teacher and in practical industrial applications of mathematics, who is Manager of Recovery Research at Sun Oil Company's Production Research Laboratory (A. V/1623). Predicated on his studies the witness Rice concluded that the averages are not good representations of the basic data because the distribution of the data is so widely spread and skewed from the mean (A. V/1626-1627).

The Commission nowhere in Opinion No. 468 makes findings that its weighted averages are typical and representative, and indeed such finding if made would be wholly unsupported. Nevertheless, the Commission brief seeks to supply such finding by its repeated comment that in time the indivdual's costs will tend to approximate the group's experience (Comm. Br. 55, 58, 111). The only references in support of the proposition (Comm. Br. 55) simply do not lead to that conclusion, however, although it is understandable that such an impression could be fostered unless the Commission's words and the citations are carefully analyzed.

The Commission brief's statement that an individual producer's costs "tend to average out over the years"[85] must not be confused with averaging the costs of many

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[85] In any event, the testimony cited by the Commission states, to the contrary, that "* * * the assumption that there is stability in the costs of a particular producer over time * * * is not true for the large producers in the Permian Basin, insofar as * * * the relatively hard costs are concerned * * *" (A. III/771-772). The testimony does state, however, that "on the basis of a test period covering five or more years * * * the amount of variability would probably be cut down" (A. III/773). At the very most this would mean there is less instability in individual producer's costs over time rather than that they "tend to average out."

producers, which is what the Commission does in its area approach. Also the statement in the Commission's brief that industry or area costs have a degree of stability from year to year cannot be related to any stability in the individual producer's costs if averaged out over a period of years. Certainly it cannot be said that the above two statements taken together mean that the individual costs averaged over a period of years will approximate group costs—even if those group costs are stable over a period of years. To illustrate, over a period of years one producer's costs, although varying in individual years and individual components, may average out to be $1.00 per Mcf. Another producer's costs, although also varying from year to year and by components, may over the same period of years average out to be 2 cents per Mcf. Still this does not mean that the average of these two averages, *i.e.*, 50.1 cents per Mcf, is representative of either of them—even if 50.1 cents per Mcf is stable over the entire period of years.[86]

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[86] In the court below the Commission brief in a similar *post hoc* attempt to support the Commission's use of averages cited to a witness who testified that averages were useful as a reflection of a producer's expectation (A. V/1641-1642). The witness also testified, however, that those expectations are unrealistic and approximated gambling habits (A. V/1643). Since Sun will not have the opportunity in brief to answer any such reference if made by the Commission in a reply brief, it should be noted that the statement cited does not indicate that averages are representative or typical of the experience of individuals, which Sun submits is the prime criteria for using averages.

II

THE COMMISSION'S NEW GAS STUDY INCORPORATES ALL OF THE ERRORS OF THE OLD GAS STUDY AND ADDS MORE ERRORS OF ITS OWN, INCLUDING PARTICULARLY THE ABSENCE OF STANDARDS

The current cost study adopted by Opinion No. 468 is largely derived from the presentation of Herman Roseman, who testified for the California Distributors. Roseman in turn acted within the framework suggested by the California Distributors' witness A. E. Kahn (A. III/1002), who had developed the approach from a theoretical standpoint, but had testified that he did not have "an optimistic feeling about the availability of data" (R. 9362-3). Nevertheless, Roseman set about to flesh out that theoretical framework with specific quantitative data. Given this task of arriving at a result, Roseman dug deep into a varied assortment of incompatible and admittedly unrepresentative sources and came up with some manner of answer which the Commission then adopted as a just and reasonable new gas price.

The sources Roseman used included the following. (1) Census of Mineral Industries for 1958; (2) Responses to appendix questionnaires; (3) Chase Manhattan Bank's Annual Analysis of the Petroleum Industry, 1961; (4) World Oil Magazine; (5) Oil and Gas Journal; (6) Joint Association Survey (JAS); and (7) American Gas Association Gas Reserve Estimates. Of these sources the responses to the appendix questionnaires have already been discussed in detail. The use of this source in the new gas study carries forward into such study those errors already shown. In addition the use of this source in the new gas study results in further error.

A. The Commission's Wholly Inconsistent Approach Toward the Representativeness of Data Illustrates the Absence of Standards

Except for the appendix data, the above sources are not broken down for the Permian Basin. Therefore, the new gas cost is purported to be derived on a national basis. Since the Permian Basin companies produce only one-third of the national gas-well gas in the test year (A. X/585d), and drilled less than 24 percent of the net drilled wells in the continental United States for the period 1955 to 1960 (A. III/939), the use of the appendix data as national costs certainly attenuates the unrepresentativeness of the data—already shown to be unrepresentative in its coverage of the more limited Permian Basin [See Presiding Examiner's discussion (A. IX/278d-280d)].

The unrepresentativeness of the Permian Basin appendix responses was fully recognized by the witness Roseman when on this basis he rejected the responses as the source for determining the cost per foot of successful wells drilled, one of the fundamental figures in his study (A. III/1005). Nevertheless, Roseman found it necessary to use the Permian appendix responses throughout his study, for trending, as absolute values, and as support for values otherwise determined (*e.g.*, A. III/1004, 1014, 1017, 1024-1025, 1030, 1038, 1045).[87] Since the Commission adopted Roseman's study virtually in its entirety,[88] of necessity it

[87] Roseman sought to defend his use of appendix data for trending (A. III/1006-1007), but not otherwise.

[88] The only components otherwise adopted were derived from a study by the producer group witness Park and resulted in lower costs than those recommended by Roseman, *i.e.*, liquid credit (A. X/588d-589d), production operating expense (A. X/584d-585d).

affirmed Roseman's rejection of the appendix data,[89] as well as its use in other components.

The appendix data was not the only instance of the schizophrenic rejection and use of a data source in the new gas study. For the same reasons that prompted the rejection of the appendix data (A. III/1005, *supra*, p. 83), the Commission also rejected the JAS.[90] Otherwise, however, the JAS was used—because it was the only published source of the desired data (A. X/581d).

Although the Commission made use of unrepresentativeness as the rationale for rejecting certain data sources where they showed higher costs, it is evident that the representativeness of its sources was not an important consideration either from the standpoint of coverages or averages. Thus no findings were made as to the representativeness of data from World Oil Magazine and the Oil and Gas Journal, and no witnesses were presented who could testify as to either the basic data behind the studies or the compositing of that data to obtain the published statistics. As to the Chase Manhattan Bank data, the Examiner found it to be derived from a nonrandom sample, expanded, by expert knowledge of the industry (A. IX/278d);

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[89] Opinion No. 468 specifically adopts the use of appendix data for trending (A. X/579d), but is silent on the rejection of the appendix otherwise and its adoption for absolute values. Important cost components taken from appendix data include operating expense (A. X/584d), regulatory expense (A. X/590d) and liquid credit (A X/588d-589d).

[90] The JAS was rejected for the same use that the appendix data was rejected. Significantly the appendix data would have produced a well drilling cost of $22.24 per foot, the JAS a cost of $18.57 per foot, and the trended Appendix data, which was used resulted in a cost of $16.89 per foot (A. III/1004-1005; IX/276d).

however, here again no witness was made available to testify as to the basic data or the expansion of the sample to industry-wide proportions.[91]

The Commission's practice in its new gas study of rejecting some data sources as unrepresentative and then using the same sources for other components of the same study clearly demonstrates that the Commission is without tangible standards for its choice of data sources. Furthermore, the Commission's close attention to the representativeness of these sources in one instance but its use of other sources with little or no concern for their representativeness is further indicia of the lack of objective standards.

The Commission has twice been reversed in its producer rate regulation efforts for its failure to provide standards, *Bel Oil Corporation* v. *Federal Power Commission,* 255 F. 2d 548, 553-554 (5th Cir. 1948), *cert. den.,* 358 U.S. 804; *Hill* v. *Federal Power Commission,* 335 F. 2d 355 (5th Cir. 1964). Yet, the Commission persists. The Commission seeks to rationalize its evidentiary deficiences in the new gas study on the ground that better evidence is difficult, if not impossible to obtain, and the witness who submitted the study was an experienced economist and statistician who carefully prepared his exhibit and was throughly cross-examined (Comm. Br. 105-107). Subjective findings of this nature could justify almost any study, but Sun sub-

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[91] The Commission brief (Comm. Br. 105, fn. 77) notes that a list of recognized data sources was prepared and the Examiner ruled that he would not sustain hearsay objections to data from these sources. The question of the representativeness of this data certainly was not determined by the Examiner's ruling which was made well before the cost phase of the case when the new gas cost study was submitted (*supra,* p. 15).

mits that more is required. The constitutional and statutory criteria discussed in the earlier portion of this brief must apply with equal force to the economic analysis denominated the new gas study if the term just and reasonable is to have meaning. Obviously the group rate making standard of representativeness has not been applied with respect to coverage in the new gas study to say nothing of the use of averages. Furthermore, even where extensive coverage was indicated for one of the data sources, that data source is otherwise obviously unreliable.

B. The Census Data Is Unacceptable for Financial Purposes Such as Rate Making

Another data source prominently used by the Commission, the Census of Mineral Industries, purports to cover 95% of the industry on a national basis, but even here there is a serious problem as to use of this data. Following this Court's determination in *St. Regis Paper Co.* v. *United States,* 368 U.S. 208 (1961), legislation was enacted to assure the confidentiality of copies of the census reports retained by the reporting entity, 13 U.S.C. § 9. In his letter recommending such legislation the Secretary of Commerce outlined problems in collecting census data and limitations on its use as follows:[92]

> "* * * In general, these questionnaires are drawn up so that they can be readily answered on a uniform basis directly from individual company records as customarily maintained. However, because of variations of the accounting systems of some companies from the customary pattern, such companies cannot furnish directly from their records the facts requested by the Census Bureau,

[92] 1962 U.S. Code Cong. and Admin. News, pp. 3190-3191.

but have to make reclassifications and regroupings of their figures, to some extent by the use of estimates, in order to provide the Census Bureau with the facts for such companies which can be combined to produce the desired totals on a uniform basis. In view of the necessity to rely in part on estimates, the companies would sometimes not consider the figures they submit to the Census Bureau as suitable for other than Census purposes. * * *

"* * * This privileged relationship enables the Census Bureau to require response to inquiries which are necessarily formulated on a uniform basis for all companies in a particular activity regardless of whether or not their books of record directly yield the requested information. *For this and other reasons estimates and approximations are necessarily acceptable in statistical reporting to an extent that would not be acceptable for financial or certain other purposes.* * * *"

Sun submits that rate making is the highest order of financial purpose and the census data so importantly relied on by the Commission (A. X/579d, 591d), is by the Secretary of Commerce's letter rendered inappropriate for such use. Sun also submits that the Secretary's letter well summarizes problems in the collection and compilation of data which are inherent in the Commission's cost studies, no matter what data sources are used. Furthermore, it is these problems which the Commission seeks to obscure by its generalized defense of the new gas study (Comm. Br. 105-107).

III

A BLANKET AFFIRMANCE OF THE COMMISSION AND THE COURT BELOW ON EVIDENTIARY MATTERS COULD WELL RESULT IN A COMPOUNDING OF THE COMMISSION'S MANY ERRORS IN FUTURE PROCEEDINGS

Sun urges in the first instance that these proceedings be reversed and remanded for the Commission to reconsider group rate making in accordance with proper constitutional and statutory standards. This position is taken on the theory that a group ratemaking proceeding undertaken in accordance with those standards must of necessity correct the evidentiary errors of this case, and hence there is little reason for the Court's review of those errors at this time. In so urging, however, Sun most certainly is not minimizing the Commission's many evidentiary errors set forth above, if this Court chooses to review the entirety of the Commission's action.

These proceedings, as the first Commission group ratemaking effort, will no doubt set the pattern for what follows. If that pattern places no restraint on the Commission as to providing standards, making findings or permitting cross-examination or rebuttal, Sun submits that future proceedings cannot be expected to improve or refine this initial effort. To the contrary, with a virtual blanket approval of the Commission's evidentiary practices herein, such as provided by the court of appeals, those practices can only deteriorate.

Whether a future Commission action involves the unreasoning adoption of Permian methods or unsupported departures from those methods, the Commission could be expected to rationalize its decision with arguments of the breadth of its discretion, the diffi-

culty of its task, and the sincerity of its efforts (*cf.*, Comm. Br. 40, 104-107). If such arguments are wholly accepted, herein, individual companies, no matter how badly aggrieved, could well consider review futile, and the Commission's future actions would go unchallenged. Sun submits that with such a prospect the Commission could hardly be expected to intensify its efforts to obtain evidence that is more representative, typical, reliable, probative or substantial than that on which it relies in this case.

IV

OTHER ERRORS OF THE POSITION TAKEN BY THE COMMISSION AND THOSE SUPPORTING IT

Sun has discussed the fundamental errors of the Commission's *Permian Basin* decision and why the area rates it has fixed under Section 5(a) of the Act must be set aside. There are also a number of other errors of the Commission, including some that this brief has alluded to, which will no doubt be discussed in more detail by other producers. Those errors include the following: the failure to include the cost of overcoming quality deficiencies in the cost of service; the failure to include gathering and processing costs in the cost-of-service; the failure to fix ceiling prices at a level that would permit revenues to equate with costs; the moratorium on rate filings and the elimination of flexible pricing provisions; the failure of the Commission to support its choice of the Permian Basin area. Sun concurs in the view that the Commission erred in each of these particulars.[93] Additionally, Sun submits

[93] Sun also is of the view that the court of appeals was entirely within its inherent powers in determining that no more than a 4½% interest rate was appropriate as a "protective device" during the pendency of the stay it granted pending litigation.

that for the reasons it has set forth in this brief, the Commission's order requiring refunds must fall to the extent that it would apply the group ceilings erroneously determined. Moreover, the producer respondents have otherwise shown in their joint brief that from a group standpoint the Commission refund order cannot stand.

A further and final aspect of this case is the question of the refunds below the "last clean rate." In its Opinion No. 468 the Commission initially required a rate schedule-by-rate schedule refund of all increases collected under Section 4 of the Act in execess of the area rates determined. In applications for rehearing, however, it was pointed out, *inter alia,* that as to some rate schedules the effect of the Commission's order could be to require refunds below rate levels previously found under Section 7 of the Act to be in the public interest, and if this were the Commission's intention, it was in effect requiring the refund of firm prices which had been permanently certificated.[94] In its Opinion No. 468-A on rehearing the Commission deferred the question for later consideration (A. XI/1117d-1118d). The court of appeals pointed out that if a producer could show it was required to refund below the last clean rate, the Commission must in any event afford it the opportunity to petition for special relief (A. XII/58).

While the California Public Utilities Commission purportedly urges affirmance of the Commission's *Permian Basin* opinion, it nevertheless seeks from this Court a substantial modification of the Commission's

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[94] See *United Gas Improvement Co.* v. *Callery Properties, Inc.*, 382 U.S. 223, 227 (1965).

orders relating to refunds by claiming that the "last clean rate" question was decided by the Commission and now is before this Court on appeal. This complex proceeding already has a plethora of issues, and the Court should not be required to decide in a vacuum this additional matter, which should be fully considered by the Commission in the first instance.

CONCLUSION

For the reasons stated above Sun submits the Commission's Opinion Nos. 468 and 468A should be reversed and remanded for the development of a system of rate making not inconsistent with the constitutional and statutory principles discussed herein, and if that system is to be a group ratemaking system, for the collection of data and the making of findings in accordance with the above-discussed principles governing group rate making.

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October 9, 1967

APPENDIX

1. The Administrative Procedure Act, Section 7(c), 60 Stat. 241, 5 U.S.C. 1006(c) provides as follows:

(c) EVIDENCE.—Except as statutes otherwise provide, the proponent of a rule or order shall have the burden of proof. Any oral or documentary evidence may be received, but every agency shall as a matter of policy provide for the exclusion of irrelevant, immaterial, or unduly repetitious evidence and no sanction shall be imposed or rule or order be issued except upon consideration of the whole record or such portions thereof as may be cited by any party and as supported by and in accordance with the reliable, probative, and substantial evidence. Every party shall have the right to present his case or defense by oral or documentary evidence, to submit rebuttal evidence, and to conduct such cross-examination as may be required for a full and true disclosure of the facts. In rule making or determining claims for money or benefits or applications for initial licenses any agency may, where the interest of any party will not be prejudiced thereby, adopt procedures for the submission of all or part of the evidence in written form.

2. The Natural Gas Act, Sections 4 and 5(a), 52 Stat. 822-3, as amended 76 Stat. 72, 15 U.S.C. 717c-717d(a) provides as follows:

SEC. 4. (a) All rates and charges made, demanded, or received by any natural-gas company for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges, shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful.

(b) No natural-gas company shall, with respect to any transportation or sale of natural gas subject to the jurisdiction of the Commission, (1) make or grant any undue preference or advantage to any person or subject any person

to any undue prejudice or disadvantage, or (2) maintain any unreasonable difference in rates, charges, service, facilities, or in any other respect, either as between localities or as between classes of service.

(c) Under such rules and regulations as the Commission may prescribe, every natural-gas company shall file with the Commission, within such time (not less than sixty days from the date this act takes effect) and in such form as the Commission may designate, and shall keep open in convenient form and place for public inspection, schedules showing all rates and charges for any transportation or sale subject to the jurisdiction of the Commission, and the classifications, practices, and regulations affecting such rates and charges, together with all contracts which in any manner affect or relate to such rates, charges, classifications, and services.

(d) Unless the Commission otherwise orders, no change shall be made by any natural-gas company in any such rate, charge, classification, or service, or in any rule, regulations, or contract relating thereto, except after thirty days' notice to the Commission and to the public. Such notice shall be given by filing with the Commission and keeping open for public inspection new schedules stating plainly the change or changes to be made in the schedule or schedules then in force and the time when the change or changes will go into effect. The Commission, for good cause shown, may allow changes to take effect without requiring the thirty days' notice herein provided for by an order specifying the changes so to be made and the time when they shall take effect and the manner in which they shall be filed and published.

(e) Whenever any such new schedule is filed the Commission shall have authority, either upon complaint of any State, municipality, State commission, or gas distributing company or upon its own initiative without complaint, at

once, and if it so orders, without answer or formal pleading by the natural-gas company, but upon reasonable notice, to enter upon a hearing concerning the lawfulness of such rate, charge classification, or service; and, pending such hearing and the decision thereon, the Commission, upon filing with such schedules and delivering to the natural-gas company affected thereby a statement in writing of its reasons for such suspension, may suspend the operation of such schedule and defer the use of such rate, charge, classification, or service, but not for a longer period than five months beyond the time when it would otherwise go into effect; and after full hearings, either completed before or after the rate, charge, classification, or service goes into effect, the Commission may make such orders with reference thereto as would be proper in a proceeding initiated after it had become effective. If the proceeding has not been concluded and an order made at the expiration of the suspension period, on motion of the natural-gas company making the filing, the proposed change of rate, charge, classification, or service shall go into effect. Where increased rates or charges are thus made effective, the Commission may, by order, require the natural-gas company to furnish a bond, to be approved by the Commission, to refund any amounts ordered by the Commission, to keep accurate accounts in detail of all amounts received by reason of such increase, specifying by whom and in whose behalf such amounts were paid, and, upon completion of the hearing and decision, to order such natural-gas company to refund, with interest, the portion of such increased rates or charges by its decision found not justified. At any hearing involving a rate or charge sought to be increased, the burden of proof to show that the increased rate or charge is just and reasonable shall be upon the natural-gas company, and the Commission shall give to the hearing and decision of such questions preference over other questions pending before it and decide the same as speedily as possible.

SEC. 5. (a) Whenever the Commission, after a hearing had upon its own motion or upon complaint of any State, municipality, State commission, or gas distributing company, shall find that any rate, charge, or classification demanded, observed, charged, or collected by any natural-gas company in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order: *Provided, however,* That the Commission shall have no power to order any increase in any rate contained in the currently effective schedule of such natural-gas company on file with the Commission, unless such increase is in accordance with a new schedule filed by such natural-gas company; but the Commission may order a decrease where existing rates are unjust, unduly discriminatory, preferential, otherwise unlawful, or are not the lowest reasonable rates.

PETITIONER'S BRIEF

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JOHN F. DAVIS, CL

No. 105

IN THE

Supreme Court of the United States

OCTOBER TERM, 1967

PERRY R. BASS, PANTHER CITY INVESTMENT CO.,
BASS BROS. ENTERPRISES, INC.,
PERRY R. BASS, INCORPORATED, AND
RICHARDSON OILS, INC.,
Petitioners,

v.

FEDERAL POWER COMMISSION,
Respondent.

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE TENTH CIRCUIT

BRIEF FOR PERRY R. BASS ET AL

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October 9, 1967

FIDELITY PRINTING COMPANY, INC., HOUSTON

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OPINIONS BELOW

The opinion of the Court of Appeals for the Tenth Circuit (XII R. 15-61)[1] is reported at 375 F. 2d 6 and the opinion on rehearing (XII R. 87-89) at 375 F. 2d 35. The opinions and orders of the Federal Power Commission (Commission) (R. 516d-826d, 827d-838d, 37s, 1105d-1132d, and 1133d-1136d) are reported at 34 F.P.C. 159, 418, 424, 1068 and 1082.

[1] Petitioners will employ the same system for citing the record used by the Federal Power Commission in its brief in No. 117.

JURISDICTION

The judgment of the Court of Appeals for the Tenth Circuit was entered on January 20, 1967 (XII R. 62-83). An order on rehearing partly modifying the original judgment was entered on April 18, 1967 (XII R. 87-89). Petition for writ of certiorari was filed on April 20, 1967, and certiorari was granted on June 12, 1967 (XII R. 89-90). Jurisdiction of this Court is invoked under 28 U.S.C. §1254(1) and §19(b) of the Natural Gas Act, 15 U.S.C. 717r(b).

QUESTIONS PRESENTED

1. Whether in determining just and reasonable area prices the Commission erred in failing to include any allowance for gathering and processing costs actually incurred by producers in the Permian Basin.

2. Whether the Commission erred in failing to give notice that quality standards were at issue and that the area prices established would be reduced by an undetermined amount for gas which did not meet such quality standards.

STATUTE INVOLVED

The Natural Gas Act, June 21, 1938, C. 556, 52 Stat. 821-833, as amended, 15 U.S.C. § 717-717w, and particularly sections 4 and 5 thereof which were set forth in the Appendix to the Commission's brief in No. 117.

STATEMENT

In general, Petitioners, Perry R. Bass, et al,[1a] have no objection to the statement of the case in the Commission's brief in No. 117. However, Bass does not have available the information required to evaluate the Commission's

[1a] Referred to herein as "Bass". This brief is directed solely to questions raised by Bass's petition in No. 105. However, Bass is also a respondent in Nos. 100, 101, 117 and 181. To avoid repetition, Bass intends to rely on briefs filed by other producers in those cases where Bass is a respondent.

recitation of the history of gas production and prices in the Permian Basin area.

A multitude of issues have been raised in the consolidated appeals[2] from the decision of the court below, which reviewed orders issued by the Commission fixing just and reasonable rates for sales of natural gas from the Permian Basin area of West Texas and New Mexico.[3] This brief will focus the Court's attention on two issues of critical importance to the proper implementation of the area rate concept sanctioned in *Second Phillips*.[4] These two issues concern (1) the lack of any allowance in the just and reasonable area prices fixed by the Commission to compensate Bass and certain other producers for their actual costs of gathering and processing and (2) the Commission's failure to give the parties notice that it intended to set minimum quality standards for sales of gas from the Permian Basin area and to provide for reductions in the area prices for gas which did not meet such standards.

The court below misconstrued Bass's argument on the first issue as an attempt by Bass to obtain special treatment because of its individual gathering and processing costs. The court concluded that "if area rates are proper no greater need exists for the consideration of the individual cost and revenue requirements in the case of Bass than in the case of the other producers" (XII R. 50).[5] Bass agrees. The

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[2] The Court has granted certiorari and consolidated the petitions filed in Nos. 90, 95, 98, 99, 100, 101, 102, 105, 117 and 181.

[3] The Permian Basin area as defined by the Commission comprises the counties of Chaves, Eddy and Lea, New Mexico, and Texas Railroad Commission Districts 7-C and 8.

[4] Wisconsin v. FPC, 373 U.S. 294 (1963).

[5] Paradoxically, at a subsequent point in its opinion the court below discussed the saving or special relief clause under review and stated (XII R. 51):

> "Some producers furnish gathering facilities. Others sell at the wellhead and the pipelines pay for the gathering. Gathering costs are allowed pipelines. Perhaps in some instances they should be allowed to producers."

very point raised by Bass is that area prices fixed by the orders under review are not proper because they do not compensate producers such as Bass for their actual gathering and processing costs. Evidently the court below was misled by Bass's use of its own situation[6] as an example of the fundamental error inherent in the Commission's failure to include in its area prices any allowance for the costs of gathering and processing services rendered by certain producers in the Permian Basin area. At the outset, Bass wishes to make it clear that its complaint is directed not at the Commission's failure to consider Bass's individual costs; instead, Bass contends that the Commission's error was in failing to consider and make allowance for gathering and processing costs incurred by all producers[7] in the Permian Basin area.

The second issue raised by Bass involves a question of procedural due process. The court below found it unnecessary to pass on this question since it assumed that any defect caused by lack of notice would be cured in the remanded proceedings which that court would require (XII R. 52). Accordingly, this issue need not be reached unless this Court should disagree with the remand required by the Court below.

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[6] Bass sells residue gas to Transwestern Pipeline Company which is produced from 664 wells on leases covering approximately 43,000 acres located in Crane, Reeves, Ward and Winkler Counties, Texas. Under its contract, Bass is obligated to gather the gas from various fields located throughout these four counties and then process and compress it before delivery to Transwestern at a single point. 28 F.P.C. 119 (1962). The Commission permanently certificated Bass's sale at a price of 18¢ per Mcf while simultaneously certificating wellhead sales to Transwestern at a price of 16¢ per Mcf, thus recognizing the appropriateness of a price differential between gas delivered at the wellhead and gas delivered after extensive gathering and processing. 22 F.P.C. 391 (1959).

[7] Of course, most sales of gas are made at the wellhead and therefore do not involve gathering and processing costs.

SUMMARY OF ARGUMENT

1. The Commission set Permian Basin area prices on the basis of the cost of exploring for and delivering gas at the wellhead. It did not allow any additional increment in such prices for gathering and treating services when performed by a producer although pipelines are compensated for performing these same services. This pipeline function, whether performed by a pipeline or a producer, is necessary and inures to the benefit of the consumer. The Commission fails to explain its omission except on grounds of administrative convenience, which must be rejected by this Court.

2. The Commission took affirmative action early in this area rate proceeding which indicated to all parties that it did not intend to consider quality standards in this proceeding. In its final decision, after the record was closed, the Commission nevertheless set minimum quality standards and related reductions in the area rates for gas which did not meet these standards. As a result, most of the gas in the Permian Basin will be reduced in price because it is below quality. The producers were denied procedural due process because they did not have notice that quality standards and related price reductions were at issue.

ARGUMENT

I.

The Commission Erred in Failing to Include Gathering and Processing Costs in Fixing Just and Reasonable Prices for Sales of Residue Gas from the Permian Basin Area

A. Introduction

From the consumer's point of view, there are basically four different phases of the gas industry. There is the local distribution system which receives the gas from the inter-

state pipeline and distributes it to the housewife. Then there is the interstate transmission of the gas in large diameter pipelines. However, before the gas enters the large diameter interstate line for long distance transmission, it must be gathered in smaller diameter lines from the various individual wells and be processed, cleaned and compressed to prepare it for its long-distance transmission. The fourth phase is the finding and producing of the gas. In some instances, either directly or through affiliates, all four functions are performed by the same company. Sometimes the interstate transmission segment owns, controls and operates part of the "preparation" segment and part of the "finding and producing" segment. The usual case is for the "finding and producing" segment to be entirely separate from the other three functions. However, occasionally, as Bass does in connection with its sale to Transwestern, the producer in addition to "finding and producing" gas also gathers, processes, cleans and compresses the gas for its interstate transmission.

In this case the Commission used its computations of the cost of *gas-well gas* to fix just and reasonable prices for sales of residue gas from the Permian Basin area. There is no question that these gas-well gas cost computations showed the cost of such gas at the *wellhead,* whereas Bass and other producers sell *residue gas* after extensive gathering and processing. Bass does not challenge any of the components of the Commission's computations of the cost of gas-well gas. Instead, Bass's argument is directed to the failure of the Commission to include any allowance for the additional costs incurred by producers who perform pipeline-type services in connection with their sales of residue gas.

B. Different Types of Gas

In order to understand the manner in which the Commission has ignored these additional legitimate costs in rendering services to the consuming public, it is necessary to understand the terminology used by the Commission since it has equated sales of different types of gas which by definition are not comparable.

Casinghead Gas

Casinghead gas is natural gas produced in conjunction with the production of oil, which the Commission sometimes refers to as oil-well gas (R. 615d). Most of the casinghead gas sold in the Permian Basin is sold to processing plants under percentage contracts, which provide that the processors shall pay to the producers a stipulated percentage of the price which the processor receives from the sale of the residue gas plus an agreed percentage of the proceeds of the sale from the liquids which are extracted (R. 616d). In its opinion the Commission stated that on this record it could not make a cost determination for casinghead gas because no realistic cost could be established in that apportionments of costs between gas and oil did not yield results which could be accepted as reliable guides (R. 622d). Consequently, the Commission used the area price (based on the cost) fixed for gas-well gas dedicated to contracts dated before January 1, 1961, to establish the area price for casinghead gas.[8] Casinghead gas receives this price regardless of when it is dedicated to interstate commerce so that, assuming there are no contractural restrictions, casinghead gas sold under a contract dated January 1, 1967 receives the same price as casinghead gas sold under contracts dated January 1, 1947 receives.

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[8] 14.5¢ per Mcf less quality deductions.

Gas-Well Gas

Gas-well gas is defined by the Commission as gas produced from wells which do not produce oil; thus it is said that such gas is produced from "nonassociated" reservoirs. Gas-well gas may be "dry" or "wet" and wet gas-well gas contains hydrocarbons which may liquefy while being produced. These hydrocarbons in the liquid phase are called condensate. Condensate is usually collected at the lease and sold by the producer at the prevailing market price, which price is not subject to regulation by the Commission. In arriving at a cost-based price for gas-well gas in the Permian Basin area, the Commission credited against the cost of finding and producing the gas the revenues received by the producers from the sale of condensate at the lease and products derived from processing, the credit being about 3.10¢ per Mcf. (R. 586d-590d) The Commission arrived at two prices for Permian Basin gas-well gas depending upon the date of the contract under which the gas is sold, January 1, 1961 being the date of demarcation. Gas-well gas dedicated prior to that date was called "old" gas-well gas and on the basis of cost calculations was given a ceiling price of 14.5¢ per Mcf, with deductions for quality deficiencies. Gas-well gas dedicated to interstate commerce after January 1, 1961, was given a price of 16.5¢ per Mcf, with deductions for quality deficiencies. *It is unquestioned by any of the parties that the prices based on costs set in this proceeding were prices for gas produced at the wellhead and that there was nothing included in the cost calculations for off-lease gathering and treating facilities.*

Residue Gas

Residue gas is the gas remaining after casinghead gas or gas-well gas as defined above has been processed in a plant built for that purpose to remove liquids in the raw gas

stream which exist in a gaseous state. Typically, the processor enters into a contract with an interstate pipeline company to take delivery of the residue gas at a single delivery point at his plant after gathering and processing. The processor then enters into contracts with many producers in which he agrees to connect the producer's well by pipeline to his processing plant and to pay the producer either stated amounts or a percentage of what he receives from the sale of the gas and the liquids extracted. Like most other processors, Bass is a substantial producer of the gas processed at its plant. The gas which goes through these gathering lines to the plant may, of course, be casinghead gas or gas-well gas as defined above and in most instances would be commingled. In the Permian Basin most of the residue gas is derived from casinghead gas although, in many of the gas-producing regions, this is not the case. At the plant, the processor also installs expensive engines for compressing the gas up to the pressures required for interstate transmission. The Commission stated that on this record no realistic cost of residue gas could be established and that practical administration of area prices dictated that casinghead gas, residue gas derived therefrom, "old" gas-well gas and residue gas derived therefrom should be similarly priced at 14.5¢ per Mcf with deductions for quality deficiences (R. 622d). It did allow residue gas derived from new gas-well the new gas-well gas price of 16.5¢ per Mcf, less quality deductions.

C. Gathering and Processing Costs Must Be Considered

The magnitude of Bass's individual gathering and processing facilities is illustrative of the substantial area costs which benefit the consumer and that the Commission has omitted in pricing residue gas. Bass owns and operates the equivalent of 253 miles of 3″ pipeline which connects hundreds of wells and gathers the gas to his plant. The

plant contains compressors aggregating 24,400 H.P. which are used solely to compress the gas to reach an adequate pressure for interstate transmission. The investment in the gathering facilities, including the plant and compressors, is 13.8 million dollars. The pipe used in the gathering facilities ranges from as low as 3″ in diameter to 26″ in diameter and the area from which the gas is gathered covers 28 square miles. At the tailgate of his plant, Bass delivers approximately 40,000,000 cubic feet of gas per day to Transwestern Pipeline Company. A typical gas well (producing gas-well gas as defined by the Commission) in this area would deliver approximately 1,500,000 cubic feet of gas per day, so that the effect of having this facility is to have approximately 27 wells located at one place. Obviously, when an interstate transmission company connects 27 different gas wells, all of those facilities go into the company's rate base and are ultimately paid for by the consumer.

Both the Commission and this Court have heretofore allowed the pipeline companies to earn a rate of return and operating expenses on similar type facilities.[9] In fact, in another area rate proceeding commenced subsequent to the instant case, the Commission Staff has recommended an increment in price for gathering facilities. In the first *Colorado Interstate* case,[10] one of the issues before this Court was whether the producing and gathering facilities of the pipeline should be included in the rate base. This Court upheld the Commission's determination that it should be. Likewise, the inclusion of gathering facilities in a pipe-

[9] The Commission's Uniform System of Accounts for pipelines recognizes that the costs of gathering facilities are a legitimate item to be included in a pipeline's cost of service. Uniform System of Accounts Prescribed for Natural Gas Companies (Classes A and B), sections 342, 343, 325-337.

[10] Colorado Interstate Gas Co. v. FPC, 324 U.S. 581 (1945).

line's cost of service was also an issue in *Panhandle Eastern Pipeline Co.* v. *FPC*, 324 U.S. 635 (1945). Again this Court upheld the Commission's inclusion of the gathering facilities in the rate base of the pipeline and the subsequent allowance of a 6½% rate of return on these facilities. Thus, it is clear that if a pipeline had to duplicate Bass's gathering, treating and compressing facilities it would be allowed to earn a rate of return on these facilities as well as operating costs.

In a pending area rate proceeding[11] to determine just and reasonable rates for gas sold in the Hugoton-Anadarko area of Texas, Oklahoma and Kansas, the Staff of the Federal Power Commission has recognized that some allowance above the ceiling price for wellhead sales must be given to those parties with substantial off-lease gathering facilities.[12] In that proceeding, the Staff pointed out in its brief to the Presiding Examiner that the delivery point assumed in that case by the Staff was the wellhead, which is also the delivery point assumed by the Commission in its cost computations in this case. The Staff concluded that if the producer gathered gas to a central point or for tailgate deliveries from plants through a substantial off-lease system an additional allowance above the basic ceiling price should be allowed for the gathering function. In fact, the Staff was quite precise and said that without further evidence, it would recommend that four major producers, Socony Mobil Oil Company, Ashland Oil & Refining Company, Skelly Oil Company, and Columbian Fuel Corporation, receive the additional recommended increment for gathering. This increment would be 1.75¢ per Mcf for gas gathered in the Hugoton Panhandle Fields and .9¢ per Mcf for gas gathered in the so-called "Other Fields". The

[11] FPC Docket No. AR64-1.

[12] Joint Initial Staff Brief, Vol. II, pp. 418-430.

Staff noted that of the four producers named above, the largest gathering system had 182 miles of pipeline and as a part of its facilities had lines ranging from 4" to 20" in diameter. As previously described, Bass's system is substantially larger and yet under the Commission's decision Bass would receive no increment for the gathering.

The consumer derives substantial economic benefit from the gathering and processing services rendered by Bass and other sellers of residue gas in the Permian Basin area. There is no question that if a pipeline installed the necessary facilities and rendered these services the resulting cost of service would have been paid by the consumer. The costs relating to such gathering and processing services cannot be ignored just because they are rendered by producers instead of by a pipeline. This is true whether such rates are regulated on an individual or on an area basis. They are actual, legitimate costs which benefit the consumer and should have been considered in fixing just and reasonable rates for sales of residue gas from the Permian Basin area.[13]

D. Fallacies Underlying the Commission's Excuses For Not Including Gathering and Processing Costs.

The Commission summarized its action in the pricing of residue gas in the Permian Basin with the following statement (R. 622d):

> "It is apparent, on this record, that no realistic cost of oil-well gas either as casinghead gas or residue gas

[13] In this case the Commission Staff estimated that the average area cost of gathering, processing and compressing residue gas was 5.59¢ per Mcf (R. 540e), whereas witnesses sponsored by producers estimated the average cost to be 6.94¢ per Mcf (R. 864, 868e, 873e). Even if the Commission is unwilling to accept either of these estimates, it would be patently unfair and unlawful for the Commission not to include some allowance for these gathering and processing costs no matter how difficult they are to ascertain.

> can be established and that the various apportionments of the joint cost of gas and oil, or gas and liquids, do not yield results which may be accepted as reliable guides. The evidence in this case and the practical administration of area rates dictates that casinghead gas, residue gas derived therefrom, and old gas-well gas should be similarly priced."

The Commission does not adhere strongly to its position that residue gas derived from gas-well gas should receive the same price as gas-well gas at the wellhead. On brief before this Court the Commission states that it recognizes there might be some situations where relief might be granted if proper price relationships do not now exist, but that it *assumed* that there were not many such situations because most of the residue gas in the Permian Basin is derived from casinghead gas. The Commission suggests that if the producers have a complaint they should request special relief. As to the just and reasonable price for residue gas derived from casinghead gas the Commission presents six arguments[14] to support its failure to consider and include an allowance for gathering and processing costs actually incurred by sellers of residue gas in the Permian Basin area. These six arguments and the fallacy in each are summarized below.

FIRST. The Commission states that except for temporary lapses, historically the average initial base price for residue gas derived from casinghead gas has been about the same as gas-well gas. The Commision's own past actions cast considerable doubt on this unsupported assertion. Bass's sale of residue gas was permanently certificated at 18¢ per Mcf. In the same order the Commission issued a certificate to Transwestern Pipeline Company authorizing an approximately $191,000,000 project to transport gas to

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[14] Brief of the Federal Power Commission, p. 155, *et seq.*

the West Coast. Two thirds of Transwestern's gas supply was located in the Permian Basin. The Commission issued certificates to the Permian Basin producers selling gas at the wellhead at a 16¢ per Mcf price as compared to the 18¢ per Mcf price allowed Bass.[15] The same California intervenors in the present case[16] participated in the Transwestern proceeding. They did not file applications for rehearing before the Commission, contesting Bass's 18¢ per Mcf rate which was the highest price which the Commission had certificated in the Permian Basin, nor did they seek judicial review. Thus, the failure of the Commission in this case to allow a price differential for substantial additional gathering and processing services rendered is utterly inconsistent with the fact that heretofore every interested party, including the Commission, has recognized that a sale of substantial volumes of residue gas at a single outlet is more valuable to the pipeline and consequently to the consumer than multiple wellhead sales which would require extensive gathering by a pipeline.

SECOND. The Commission argues that gas-well gas tends to have a greater value that casinghead residue gas because its availability does not depend on state oil allowables. However, the Commission conceded in the orders under review that ordinarily processing plants schedule their deliveries from various wells which they service in such a manner as to maintain a substantially even output. Thus irregularities in deliveries from particular wells are

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[15] Bass had negotiated a contract price of 21.8¢ per Mcf which was substantially higher than prices paid by Transwestern for wellhead sales, so that if "free" market action is relevant, the marketplace obviously appreciates the difference between residue gas and wellhead sales.

[16] Pacific Lighting Gas Supply et al. and the Public Utilities Commission of the State of California et al. These intervenors before the Commission and in the court below are petitioners in Nos. 90 & 100.

overcome to some extent. (R. 616d) Further, the Commission's inference that only oil production is regulated by the state produces a false assumption. Gas-well gas production also depends upon the allowables set by state regulatory bodies. Neither oil nor gas flows every day of a particular month regardless of the allowables, as the oil or gas allowable is stated as a total amount for the month, which can be produced by the producer and the pipeline at such times as they mutually agree.

THIRD. After noting the producer's attack on the pricing of casinghead gas and the failure of the Commission to consider the gathering and processing costs incurred by processing plants, the Commission makes the statement that: "However, to challenge the oil-well gas price because not all items that might be included in costing that type of gas were considered in costing the yardstick gas, overlooks both that oil-well gas cannot be costed realistically and that the price equivalents accurately reflect the practices of the market."[17] This statement refers to casinghead gas at the wellhead and is beside the point. Bass disputes the fact that the above-ground gathering and processing facilities cannot be accurately and realistically costed. After all, they are the only truly utility-type facilities in the proceeding and the Commission aways calculates their cost in pipeline rate cases.

FOURTH. The Commission argues that producer-processors such as Bass are not suffering any out-of-pocket losses in selling their processed gas at the wellhead price of gas-well gas. To substantiate this assertion, the Commission then refers to selected cost evidence, which it has rejected as not being realistic or yielding acceptable results, and upon which it did not make a finding. This argu-

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[17] Brief of the Federal Power Commission, p. 157.

ment is truly amazing — "We cannot determine the cost of residue gas but we justify our conclusion on the basis of cost." Bass will not waste the Court's time with a point by point counter-argument of what various cost evidence, rejected by the Commission, would have shown. The Commission refused to allow Bass, among others, to present any individual cost studies to show their actual costs. It ignored the only record evidence of costs incurred after gas leaves the wellhead. It cannot ignore plant costs as "unrealistic" and "too imprecise" and then reverse itself and argue that the area prices allowed for residue gas are justified by a cost-revenue analysis. This inconsistency is a reflection of the untenable position in which the Commission finds itself.

FIFTH. The Commission argues that its area pricing system allows producer-plant operators a higher price if they actually improve the gas by bringing it up to pipeline quality, therefore, directly compensating them for the processing service they perform quite apart from the valuable benefits accruing to them from the liquids extracted in the processing operation. Bass does not dispute the argument but it is not applicable to Bass's sale or to many other plant sales in the Permian Basin. Bass purchases the gas at the wellhead under percentage-type contracts which provide that the producer at the wellhead receives a percentage of the price per Mcf received from the interstate pipeline purchaser plus a percentage of the liquids derived from processing. The contract filed with the Commission to which the Opinion No. 468 price-reducing provision relates, covers a single sale by Bass as plant operator to an interstate pipeline company. Any reduction in the price at this point because of quality standards equally affects Bass and the producers at the wellhead.

This argument ignores not only the cost of gathering the gas but the Commission's treatment of the price reductions

caused by its quality standards. The Commission's orders specify a delivery pressure of 500 psig with a Btu content of 1000; anything less requires a price reduction for being deficient. Bass utilizes 24,000 H.P. of compression to deliver gas to Transwestern at a pressure of 600 psig with an average Btu content near 1050 and with a hydrogen-sulphide content better than the standard set by the Commission. When the contract was originally negotiated all of these factors, among others, were taken into consideration to determine the price. However, the Commission's orders do not allow any *upward* price adjustment for delivering gas which exceeds the pressure standard or Btu standard (unless the Btu exceeds 1050). In other words, Bass has installed enough compression to exceed the Commission's specified pressure by 20%, thus saving the pipeline from having to install this compression but will receive a price reduction below the ceiling price because of excessive hydrogen-sulphide content.

SIXTH. Finally, and weakly, the Commission notes that it allows pipelines to include all of their plant costs but normally requires them to credit all of their liquid revenues to the cost of service, whereas, producer-plant operators may, of course, retain their liquid revenues. Of course, a portion of the plant and gathering costs which the producer incurs are attributable to its liquid revenues and that portion should be credited to the liquid revenues. However, there could scarcely be any question that a portion of the gathering and processing costs are attributable to the residue gas stream delivered to the interstate transmission company and those costs should be allowed in arriving at the price of the gas. Yet the Commission completely ignored such costs in setting just and reasonable prices for sales of residue gas.

E. Conclusion

In summary, it appears that the real reason the Commission seeks to deprive Bass and other residue gas sellers of fair payment for additional gathering and processing services performed is administrative convenience, *i.e.*, the Commission does not want to make what it considers to be difficult allocations of joint costs associated with such services. This is the type of excuse successfully urged by the Commission in *Callery*[18] for not allowing any cost evidence in a certificate proceeding and in *Second Phillips*[19] for adopting the area pricing approach. However, at some point administrative convenience must yield to legitimate claims for reasonable compensation for costs actually incurred in rendering service to the consuming public. Difficult allocation problems are an important part of the Commission's regulatory function. There is no valid reason why the Commission could not have calculated and included in the just and reasonable area prices the costs of gathering and processing actually incurred by Bass and other sellers of residue gas in the Permian Basin area. There was ample evidence in the record from which such costs could be determined.[20]

The effect of the orders under review is to grossly discriminate against producers such as Bass because they are allowed the same price for residue gas centrally gathered, processed and compressed as other producers are allowed for gas delivered at the wellhead. The future effect of such a discriminatory procedure will be that producers will never again perform the "preparation" segment of the gas industry, but will contract with the interstate pipelines for wellhead delivery, still retaining a percentage of the liquid

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[18] United Gas Improvement Co. v. Callery Properties, Inc., 382 U.S. 223 (1965).

[19] Wisconsin v. FPC, 373 U.S. 294 (1963).

[20] See footnote 13, *supra*.

hydrocarbons removed by processing. Of course, the consumers will pay for these pipeline facilities in their rates. If the area rate method of determining just and reasonable rates has any validity, the Commission must recognize that in some instances producers, such as Bass, perform extra services which have an objectively measurable value to the consumer. The failure of the Commission to include an allowance for such gathering and processing services performed by these producers is arbitrary and capricious, not supported by substantial evidence, and cannot be hidden under the guise of administrative convenience.

II.

The Producers Were Denied Procedural Due Process on the Quality Standards Issue

Perhaps the most provocative aspect of the orders under review was the Commission's specification of quality standards for gas produced from the Permian Basin Area. Intentionally or not the Commission had led the producers and its own staff into believing that quality standards were not at issue in the proceeding but would be considered in a pending rule-making proceeding.

The prescribed quality standards relate to the quantity of carbon dioxide, water, sulphur, and other impurities contained in the gas and the pressure at which the gas is delivered. The Commission provided that if gas did not meet the prescribed quality standards, the area ceiling prices were to be reduced by the actual cost to the pipeline of processing and/or compressing the gas to meet such standards. The Commission also provided that initially the producer and the pipeline shall agree upon the cost of processing and/or compressing the gas to meet the prescribed quality standards. Such agreements are to be filed with the Commission for its approval.

The court below (1) reversed the Commission because the revenue impact of its decision could not be determined with unknown quality deductions (XII R. 58-61); (2) stated it did not understand the Commission's treatment of the BTU quality standard (XII R. 53); and (3) did not decide the producers' claim that they had been denied procedural due process because of lack of notice that quality standards was an issue (XII R. 52). Bass has been granted certiorari on the procedural due process question.

As the Commission points out in its Brief,[21] early in the hearing the producers filed a motion asking that a pending rule-making proceeding previously initiated by the Commission inquiring into the establishment of quality standards for gas be consolidated with the proceeding to determine just and reasonable rates for the Permian Basin Area. The motion was denied by the Commission. It is necessary to understand how the Commission uses its rule-making powers to realize the significance of the denial of this motion to a knowledgeable Federal Power Commission practitioner. The Commission has determined that certain issues in the regulation of producers arise in every case and that rather than consider these questions on an *ad hoc* basis, it is more expeditious to have one general hearing devoted to the recurring question and apply the judgment resulting from that hearing to all producers in the future. For example, the Commission in a rule-making proceeding determined that it would not allow the producers to file contracts with indefinite price escalation clauses. The producers appealed, contending that the Commission must consider each application individually on its own merits, but in *FPC* v. *Texaco Inc.*, 377 U.S. 33 (1964), this Court ruled

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[21] Brief of the Federal Power Commission, p. 154.

that the Commission did not exceed its authority in utilizing these rule-making proceedings in this manner.

When the present proceeding commenced, it was obvious to the producers that quality standards would be considered in arriving at proper just and reasonable area prices. Thus, the producers *initially* introduced evidence on the quality question and asked the Commission to consolidate its pending rule-making proceeding with the area rate case so that quality standards for Permian Basin gas could be determined in this case. When the Commission denied this motion, anyone familiar with its procedures would have interpreted the denial to mean that it did not intend to consider quality standards in this area rate proceeding, but preferred to do so in a rule-making docket. Thus, the producers abandoned their attempt to present evidence on the quality standards issue, as eventually did the Commission's staff. The Examiner accurately summarized the record with regard to quality standards stating (R. 249d):

> *"It is extremely difficult in this case, and probably impossible on this record, to establish a complete set of differentials for the various value and quality characteristics of gas.* As has been described above, the contracts embody a multiplicity of provisions reflecting many items of negotiation between the buyer and the seller. The cost elements cannot really be isolated because this involves all of the frailties of the allocations used in determining the 'cost' of producing and processing gas. The CPUC advocates using the differentials proposed in the Commission's Notice of Proposed Rulemaking in Docket No. R-200, *but there is no basis in this record for adopting them.* Staff virtually abandoned efforts at quality differentials, and its price structure permits practically all gas of the same type to sell at the same ceiling regardless of its quality and value . . . (Emphasis supplied)"

The producers were "entitled to be fairly advised of what the Government proposes", *Morgan* v. *United States*, 304 U.S. 1 at 18-19. Under the circumstances of this case, the Commission's affirmative action in rejecting the producer's motion described above could only indicate that the Commission was not going to consider quality standards in this case. Basic fairness guaranteed by the Fifth Amendment to the Constitution of the United States requires that this portion of the case be returned to the Commission for supplemental proceedings in which all parties will be advised of what they are expected to present and afforded an opportunity to present evidence on the quality standards issue.

CONCLUSION

WHEREFORE, Petitioners, Perry R. Bass, Panther City Investment Co., Bass Bros. Enterprises, Inc., Perry R. Bass, Incorporated, and Richardson Oils, Inc., respectfully request that Opinions Nos. 468 and 468-A and accompanying orders be set aside for each and all of the reasons set forth herein.

Respectfully submitted,

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October 9, 1967

JOINT BRIEF

Nos. 261 and 262

OCT 23 1967
JOHN F. DAVIS, CLERK

In the Supreme Court of the United States

October Term, 1967

THE PERMIAN BASIN AREA RATE CASES

On Writs of Certiorari to The United States Court of Appeals for the Tenth Circuit

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JOINT BRIEF FOR THE CITY OF SAN DIEGO AND THE CITY AND COUNTY OF SAN FRANCISCO

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In the Supreme Court of the United States

October Term, 1967

Nos. 261 and 262

THE CITY OF SAN DIEGO, a municipal corporation, and THE CITY AND COUNTY OF SAN FRANCISCO, a municipal corporation,
Petitioners,

vs.

SKELLY OIL COMPANY, et al.,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

JOINT BRIEF FOR THE CITY OF SAN DIEGO AND THE CITY AND COUNTY OF SAN FRANCISCO

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Tenth Circuit, issued on January 20, 1967 (XII R. 12-61),[1]

1. The record in this Court consists of fourteen volumes, thirteen of which constituted the joint appendix in the Court of Appeals. Volumes I-V, which contain only testimony before the Commission, are paginated 1-1908 (bottom of page) and will be cited "R.1 - R. 1908". Volumes VI-VIII, which contain exhibits presented during the hearings, are paginated 1e-1146e and will

and its *per curiam* opinion and order on rehearing, issued on April 18, 1967 (XII R. 87-9), are reported at (10 Cir., 1967) 375 F.2d 6. The Federal Power Commission's Opinion and Order Determining Just and Reasonable Rates for Natural Gas Producers in the Permian Basin, Docket No. AR61-1, *et al.* (Opinion No. 468), the related Order Issuing Certificates, and the related Order to Show Cause issued on August 5, 1965 (R.516d-838d, 37s-40s), are reported at 34 FPC 159, 418, and 424 respectively; and its Opinion and Order Denying Applications for Rehearing of Opinion No. 468, Docket No. AR61-1, *et al.* (Opinion No. 468-A), issued on October 4, 1965 (R.1105d-1136d), are reported at 34 FPC 1068. The initial decision of the Presiding Examiner, issued on September 17, 1964 (R.97d-364d), is reported at 34 FPC 306.

JURISDICTION

The judgments of the Court of Appeals were entered on January 20, 1967. They were modified by an order on rehearing entered on April 18, 1967. Petitioners did not petition for rehearing before the Court of Appeals. On April 15, 1967, Mr. Justice White extended the time for filing a petition for a writ of certiorari on behalf of The City of San Diego to June 19, 1967. The same extension was given by Mr. Justice White to the City and County of San Francisco on April 19, 1967. The petitions were duly filed and certiorari was granted on October 9, 1967. The jurisdiction of this Court is invoked under the provisions of 28 U.S.C., §1254(1), and Section 19(b) of the Natural Gas Act (15 U.S.C., §717r, para. (b)[2]).

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be cited "R.1e - R.1146e". Volumes IX-XI, which contain pleadings, orders, and opinions in the Commission proceedings, are paginated 1d - 1157d and will be cited "R.1d - R.1157". Volume XII (the only tan-covered volume), which includes the decision of the Court of Appeals and other items from the file in the court below, is numbered 1-90 and will be cited "XII R.1-90". There are also two small volumes - a supplement to the joint appendix below paginated 1s-40s, and a table of contents for Volumes I-XI.

2. Act of June 21, 1938, c. 556, §19, 52 Stat. 831, as amended 15 U.S.C., §717r, para. (b) (1958).

QUESTIONS PRESENTED

The main issue in this case is whether or not the Federal Power Commission has acted properly under the Natural Gas Act, as interpreted by this court, in setting an area price for natural gas produced in the Permian Basin. The main questions are:

1. Does the area price based on a fair relationship between area costs and area revenues meet the end result test of the *Hope* case?[3]

2. Does the application of the area method require refunds be made on an individual schedule basis?

3. Was the lower court correct in remanding the case for further hearings? Within this question are these issues:

a. Can any good purpose be served by additional hearings considering the further delay and cost to consumers?

b. Has the FPC abused its administrative discretion by not specifying all the circumstances which would merit exception from the area price under the relief provision?

c. Are the quality deductions as set by the Commission proper and based on sufficient information?

d. Has the BTU gap been adequately explained?

e. Was the record adequate to allow review of the 12% rate of return?

f. Should the area rate also serve as the proper initial certificate price under Section 7 of the Act?

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3. *Federal Power Commission* v. *Hope Natural Gas Co.* (1944) 320 U.S. 591.

STATUTES INVOLVED

The relevant provisions of the Natural Gas Act (Act of June 21, 1938, c. 556, 52 Stat. 821-833, as amended, 15 U.S.C., Sections 717-717w) are set forth in the appendix to this brief.

STATEMENT OF THE CASE

The problem of how to regulate effectively natural gas producers first came to the attention of this court in *Phillips Petroleum Company* v. *Wisconsin* (1954) 347 U.S. 672, hereafter referred to as *"First Phillips."* The events and decisions which occurred over the next nine years are ably set out in Mr. Justice Harlan's majority opinion in *Wisconsin* v. *Federal Power Commission* (1963) 373 U.S. 294, reh. den. (1963) 375 U.S. 870, hereafter referred to as *"Second Phillips."* The result of nearly a decade of effort was to discard the traditional individual cost of service method of regulation in favor of a proposed area approach.

The Federal Power Commission acted to effect the development of the area ratemaking method by instituting a new proceeding. The area selected was the Permian Basin which is located in southeastern New Mexico and western Texas. Its most important natural gas distribution area is California.

Hearings in the Permian Basin case began before the FPC on October 11, 1961. The proceedings involved 251 days of hearings, a transcript containing 30,369 pages, and some 337 exhibits. Hearings concluded on September 12, 1963.

Following the filing of briefs by the parties, the matter was submitted to the hearing examiner for his initial decision.

That decision was rendered on September 17, 1964. Oral argument was heard by the full Commission commencing February 8, 1965. Its decision, No. 468, was issued on August 5, 1965. (R.516d-838d) The decision detailed a comprehensive scheme of regulation for jurisdictional sales of natural gas from the Permian Basin area.

After petitions for rehearing were filed, the Commission issued Opinion No. 468-A on October 4, 1965. Opinion No. 468-A denied the applications for rehearing, but modified the initial opinion where the Commission deemed appropriate. (R.1105d-1136d)

The first of the producers to file a petition for review by the Court of Appeals for the Tenth Circuit was Skelly Oil Company which did so on September 13, 1965. Its fellow producers, respondents herein, followed Skelly's lead. The opinion of the Court of Appeals was issued on January 20, 1967. The Court remanded the proceedings to the Commission for further hearings. (XII R.12-61)

On April 18, 1967, the Court of Appeals issued a *per curiam* opinion and order on rehearing. (XII R.87-89) The order made a significant change in the treatment to be accorded refunds collected under section 4e of the Act, and suspended the Commission's concurrent certificate order.

The Federal Power Commission has throughout this maze of administrative and judicial proceedings attempted to effect regulation through an "area" method. The lower court, while purporting to approve it in principle, has found enough defects to require, in its opinion, further administrative development.

The cities of San Diego and San Francisco intervened in these proceedings and have participated throughout. San Diego, with a population of 687,200, is the sixteenth largest city in the United States. It has a metropolitan area with a

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population slightly in excess of 1,000,000. San Francisco has a population of 747,000, and is the ninth largest city in the United States. It is the financial center of northern California with a metropolitan population in excess of 3,000,000. San Francisco and its consumers purchase approximately 9% of all natural gas sold by the Pacific Gas and Electric Company. Natural gas is depended upon as the major source of energy for residential and industrial use in both cities. The supply of natural gas at just and reasonable prices is of vital importance to the petitioners and their residents.

The Cities of San Diego and San Francisco and their residents must, when these proceedings are finally settled, pay the rates established by the Commission. The orders as they stand now would result in rate reductions. In addition, if the Commission ruling on refunds is affirmed, the consumers of our communities will recover substantial sums. The interest of the cities is clear.

SUMMARY OF ARGUMENT

The Natural Gas Act and this court's decision in *Second Phillips* charge the Federal Power Commission with the responsibility for setting a fair and reasonable price for jurisdictional sales of natural gas. The problem of how best to discharge that responsibility is again before this court.

After a time consuming, complex, expensive administrative process, the Federal Power Commission rendered its area price decision. The lower court has suspended the order pending further proceedings before the Commission. Once again the producers have prevailed. They have won the delay which throughout the history of this litigation, now approaching two decades, has acted to frustrate effective regulation and defeat consumer interests.

The Commission, acting within proper administrative discretion has developed a regulatory method which is well within the guides set by this court in *Federal Power Commission* v. *Hope Natural Gas Co.* (1944) 320 U.S. 591, hereafter refered to as *"Hope"*, and *Second Phillips*. Acting pursuant to the tentative approval given the area method in *Second Phillips,* the Commission set a rate which accomodates the legitimate needs of the investor, the consumer and the industry. The rate was based on actual and historic costs and included generous amounts for the research, develment and exploration necessary in the industry to insure an adequate supply of gas. The end result is a fair one.

The lower court was presented with an order based on an extensive and complete record. No good purpose can be served by requiring that it be expanded by further proceedings. A final determination on area pricing can be made on the present record. The Commission's decisions on the rate of return, relief provisions, quality standards, price differentials tied to heating properties, and the certificate order, were all based on sufficient material in the record. All of the order is consistent with the area pricing method. All decisions were within the limits of fair and reasonable regulation.

The refund provision of the Natural Gas Act is of special interest to the consumers of San Diego and San Francisco. It allows the companies to receive their higher prices subject to refund should they be found unreasonable. (Section 4e) History has shown this type of relief is less than satisfactory. Further delay will only occasion the accumulation of more refunds in an already distended fund. A lower price through effective regulation would afford consumers a far superior and more certain protection.

The lower court would only allow refunds if area revenues exceed area costs. Such a ruling conflicts with the tenets of

area pricing and past decisions of this court. The area price contains allowances for bad individual company years within industry averages. If a company consistently fails to meet its revenue requirements it can leave the industry. An effective free market would decree the same result.

The area price is not a perfect method of regulation. It is, however, workable and enforceable. The consumers of San Diego and San Francisco have been waiting over fifteen years for fair gas prices. The Commission order is a fair accommodation and should be affirmed.

ARGUMENT

I.

Upholding the Federal Power Commission in its Area Rate Decision is the Only Course Consistent With the Expressed Intent of Congress and This Court; That the Natural Gas Industry be Regulated in the Public Interest

A. THE HISTORY OF THIS LITIGATION CAN BE DESCRIBED IN THE SINGLE WORD, "DELAY", WHICH HAS PREVENTED EFFECTIVE REGULATION

The opinions below[4] and our statement of the case[5] make clear that effective regulation has been too long delayed. The sizes of San Diego and San Francisco and the number of gas users there underlines our interest in seeing an end to that delay. Under the law,[6] our consumers have a right to receive gas at a "fair and reasonable" price. The problem which has consumed a vast amount of time, money, and administrative and legal talent is to give meaning to those deceptively simple words "fair and reasonable."

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4. *Supra*, pp. 1, 2.

5. *Supra*, pp. 3, 4.

6. Natural Gas Act (Act of June 21, 1938, c. 556; 52 Stat. 821, 15 U.S.C. §§717-717w, as amended).

The FPC was charged with regulatory responsibility over gas producers 14 years ago in *First Phillips*. They began the job with a traditional public utility "individual cost of service" approach. The result of that effort came before this court in *Second Phillips* ten years later. The FPC had solved the problem by dismissing the case. As a result, millions of dollars of refunds due to consumers were lost; producers continued to set their own prices; there was no regulation. The dismissal was upheld by a divided court. They agreed with the FPC that: the "individual cost" method was not useful in the gas industry; the problem of regulation was an economic one; and the most promising procedure was to set rates for the whole area rather than one company.

The effect of the decision, apart from its merits, was to put off again the date when the Phillips Company and other similar producers would be regulated to insure their operation in the public interest. The producer group seemed to agree with the FPC that the area approach was worthy of further study. The case with all its potential benefits to consumers in the form of reduced rates and refunds was dismissed. Rather than reach a decision for the Phillips Company under the old method and then proceed with the area experiment, it was decided to include Phillips in the new area determination.

The FPC has now made its area decision. It is clear if this decision is remanded for new hearings the result will be another circuit court decision, more petitions, rehearings, and perhaps another Supreme Court case. Another lengthy time period will pass and still the consumers will be without the protection given them by law. To some observers it has even appeared that area pricing is but another stratagem created by the producers' bank of legal talent again to defeat effective regulation.

The arguments made by the various producers over the years in these proceedings are interesting. Before this court's decision in *Hope* the producers were united in opposition to the individual cost of service method of regulation. After the *Hope* decision, the same group argued that the individual company method was the only one permissible under the law. In *Second Phillips* the companies agreed that perhaps area pricing was the only fair way to regulate the industry. Now the arguments aim at proving the area concept is somehow defective. The arguments change but the practical result is always the same. Behind the changing pattern of their legal arguments is a leering beast named "delay." The producers can always find defects or propose alternatives. Even if one assumed that a good portion of their current arguments are correct, the loss to the companies is small when compared to that borne by consumers in the absence of regulation. They should not be allowed to prevail again.

B. ALLOWING THE REMAND ORDER OF THE TENTH CIRCUIT TO STAND WILL CAUSE MORE DELAY AND POSTPONE AND POSSIBLY DEFEAT ANY FUTURE REGULATION

Other parties to this action have filed extensive briefs in support of the area pricing scheme. Good arguments can be made in support of the area method. The gas production industry is different economically from the typical public utility. Justice Jackson in *Hope* described the differences in detail. The FPC has acted within the applicable legislative and judicial guidelines to produce a regulatory method which conforms to the particular needs of the industry. Area pricing can be shown to be an effective means of regulation. We will admit that it may not be perfect, but it is enforceable. It will give some relief to consumers without undue injury to the industry. Defects can be worked out and improvements made. To allow the remand would only put off regulation.

The sorry history of the gas cases would have another chapter. The consumer once again would be the loser.

This court is faced with the choice of affirming the FPC in its area determination or remanding for further proceedings of unknown duration. The court considered a similar choice in *Second Phillips* (373 U.S., at 311-312) and said:

> Such a remand undoubtedly would have consumed considerable time and energy, including that of the Commission and its staff, and would almost certainly have involved another decision by a hearing examiner, another appeal to the Commission, another petition for rehearing and further judicial review of complex and difficult issues. In short, the alternative rejected by the Commission would not have resulted in definitive regulation of Phillips' rates immediately or in the near future. Indeed, several years might have elapsed before even the method of regulation which the Commission regards as unsuitable would have become effective as to even this one producer.

There is no indication the remand here if allowed will be any less time consuming that the one described above. We will discuss the merits of the remand order in a late portion of this brief. We do here wish to emphasize the injury to consumers due to the delay which would result if a final decision on this case is put off again in the hope of achieving some "better" scheme in the future.

There is an additional danger present in any continuance of a technically complicated regulatory proceeding. The record before this court in *Second Phillips* was, like the case at a bar, a product of a long administrative process, yet a proper result was thought to require further information. The original record had become "stale." The course taken by this case could easily match that of its predecessor. By the time the case proceeds through the various stages and comes here again the area price will be history.

This court recognized the problem in *Second Phillips* (373 U.S., at 311, n.18) and disposed of it by saying:

> The fact that this record may have been stale by the time the Commission rendered its decision certainly does not mean that no rate proceeding can be decided before the record becomes out of date. This pilot proceeding was one of unusual length and complexity, and the Commission noted that both costs and revenues "increased greatly" between the test year and the year of decision. The Commission has presumably learned a great deal in this case which will be of use to it in the area proceedings, and there is no reason to suppose that those proceedings will be rendered incapable of decision by the march of time.

It appears the case at bar is another "pilot project." There is no reason to suppose that costs in light of the defense induced inflation will remain constant, nor that the next case will be any less complex, nor that the Commission's experience will be any greater under an area approach which has not as yet been tested. There is a real possibility the test year will become stale, thereby necessitating even more hearings before a final decision is made.

This court has abandoned the individual cost method. The producers seem to argue the area approach is also defective. The lapse of time necessary to generate a "complete and perfect record" could well render the whole problem moot thereby frustrating the purpose of the Natural Gas Act by defeating meaningful regulation.

II.

The Permian Basin Ruling by the Federal Power Commission was Proper Under Applicable Principles of Statutory Administrative and Constitutional Law and Should be Affirmed

A. THE SUPREME COURT HAS TENTATIVELY APPROVED THE AREA RATE APPROACH

The Congress of the United States has decided that, for various reasons, the market has failed as a regulatory mechanism over the natural gas industry. As a result the Natural Gas Act directs the Federal Power Commission to set rates that are "just and reasonable."[7] The FPC has acted under that mandate as applied by this court in *First Phillips* to gas producers. The initial attempt at regulation was found wanting in *Second Phillips*. For a number of reasons the FPC decided and this court agreed that individual cost of service was not a feasible means of regulation for gas. The FPC began its area price project as the only reasonable alternative with the approval of this court. This court in approving the dismissal of the Phillips Company proceeding in *Second Phillips* stated it would be wrong to do so if the proposed method of the FPC " . . . were almost sure to fail. . . ." (373 U.S., at 308). This court proceeded to say:

> We recognize the unusual difficulties inherent in regulating the price of a commodity such as natural gas. We respect the Commission's considered judgment, backed by sound and persuasive reasoning, that the individual company cost-of-service method is not a feasible or suitable one for regulating rates of independent producers. We share the Commission's hopes that the area approach may prove to be the ultimate solution. (*Second Phillips*, 373 U.S., at 310)

While the product of the Commission's judgment may not be the "ultimate" answer, petitioners urge it is an acceptable compromise made pursuant to legitimate administrative discretion and should be affirmed.

B. THE FPC HAS ACTED WITHIN PROPER ADMINISTRATIVE DISCRETION TO DEVELOP AREA PRICING

This court in its discussion of the Commission's action in *Second Phillips* (373 U.S., at 309-310) said:

> The Commission has stated in its opinion in this

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7. Natural Gas Act (15 U.S.C. §717d)

> proceeding that the goal is to have rates base on the "reasonable financial requirements of the industry" in each production area, 24 FPC, at 547, and we were advised at oral argument that composite cost-of-service data will be considered in the area rate proceedings. Surely, we cannot say that the rates to be developed in these proceedings will in all likelihood be so high as to deprive consumers, or so low as to deprive producers, of their right to a just and reasonable rate.

The proceedings below have developed a method of regulation which is well within the limits thus prescribed by this court. The FPC considered both actual and historical costs in setting the high and low price for gas. A substantial allowance was included to provide for the current and future financial requirements of the industry. Arguments could be made that the Commission has favored the companies at the expense of consumers. However, in order to simplify the proceeding and obtain some regulation, petitioners concede the consumers are also sufficiently protected.

It is well settled that an agency choice between legally permissible regulatory methods is entitled to great judicial deference. *Federal Power Commission* v. *Natural Gas Pipeline Co.* (1942) 315 U.S. 575, 586, 607 (concurring opinion); *Federal Power Commission* v. *Hope Natural Gas Co.* (1944) 320 U.S. 591, 602; *Wisconsin* v. *Federal Power Commission* (1963) 373 U.S. 294.

Of necessity, a complex and highly technical problem solved by expert staffs after years of hearings and study can not be totally re-examined by a court. The decision, if rational, must be respected. This court has made clear that there is no single fixed formula for finding just and reasonable rates. *Federal Power Commission* v. *Natural Gas Pipeline Co.* (1942) 315 U.S. 575, *Federal Power Commission* v. *Hope Natural Gas Co.* (1944) 320 U.S. 591; *Colorado Interstate*

Gas Co. v. *Federal Power Commission* (1945) 324 U.S. 581. The area price developed by the Commission was not approved by the Tenth Circuit. Petitioners appreciate the lower court's concern with insuring proper judicial review of complicated regulatory decisions. However, the lower court seems to have overlooked some important words from the *Hope* case (320 U.S., at 602):

> The Commission's order does not become suspect by reason of the fact that it is challenged. It is the product of expert judgment which carries a presumption of validity. And he who would upset the rate order under the Act carries the heavy burden of making a convincing showing that it is invalid because it is unjust and unreasonable in its consequences.

There has been no showing that the rate order in the case at bar was unjust or unreasonable in its consequences.

This court has declared on several occasions: "A rate order cannot be upset on judicial review unless confiscation is clearly shown." *Los Angeles Gas & Electric Co.* v. *Railroad Commission* (1933) 289 U.S. 287; *Lindheimer* v. *Illinois Bell Telephone Co.* (1934) 292 U.S. 151. Justice Reed dissenting in *Hope* said it well and restated a generally accepted principle of law, "Such. . . (a) . . . test is not precise. The agency charged with its determination has a wide range before it could properly be said by a court that the agency has disregarded statutory standards or has confiscated the property of the utility for public use." (320 U.S., at 621)

The area price keyed to the experience of the industry amply provides for current expenses as well as future expansion. The high cost producer who proves unable to operate under the rate scheme is free to leave the industry. If the industry as a whole is hurt the rates can be adjusted. It has never been held that regulation guarantees a profit. *Federal Power Commission* v. *Natural Gas Pipeline Co.* (1942) 315 U.S. 575,590; *Federal Power Commission* v.

Hope Natural Gas Co. (1944) 320 U.S. 591, 603. The market itself often ends the life of high cost operations. The area method of regulation does no more.

None of the alleged defects in the Commission order are so harsh on the producers to result in confiscation. The Commission has attempted to reasonably and fairly accommodate conflicting interests and its decision is well within any constitutional limitations on administrative action.

III.

The Record Below in Which the Area Approach Was Developed Was Adequate for Effective Judicial Review and the Tenth Circuit was in Error to Remand the Case for Further Proceeding

A. THE FPC METHOD MEETS THE REQUIREMENTS OF *HOPE* AND *SECOND PHILLIPS.*

We have already seen the pattern of this action which is to delay as much as possible and thereby defeat regulation. This court has tentatively approved a new area approach. The FPC acted to produce a workable scheme under this approach. The FPC ruling should have been affirmed in its entirety.

The basic problem for the Tenth Circuit was that it was unable to keep clear the difference between individual company cost of service regulation and area pricing. The court stated it approved the area concept. In its discussion of high cost producers the court recognized a well-settled principle of regulation, "that it was not necessary to fix rates so high that all agencies in the business could make money." *Skelly Oil Company* v. *Federal Power Commission* (10 Cir. 1967) 375 F.2d 6, 28. Yet on the preceding page the court held that the FPC scheme fell short of the constitutional standard set in *Hope* because the FPC had not provided the producer would recover, ". . . its prudent operating

expenses and capital costs with a return commensurate to the risk and sufficient to attract capital." (375 F.2d 6, 27).

There is no doubt the area price meets the requirements set out in *Hope* for the *industry as a whole*. By a "fair relationship," the FPC meant the rates would provide the required revenue and attract capital to the industry as a unit. The producers would profit and the consumers would receive a lower price as a result of the regulation. The area price relies to a great extent on actual cost information to insure a fair result. The "composite cost-of-service data" has been considered and incorporated into the Commission's price determination in accord with *Second Phillips*.

To be sure, some producers may not recover all their costs as the FPC has defined them. It is important to understand the "costs" as defined are an economic construct and not an accounting footing. Much of the price figure set by the FPC allows for future expansion, research, exploration, and the like. No account was taken of tax advantages received by gas producers nor incidental revenues from salable liquids. There is little doubt the FPC has allowed ample return to companies for lifting gas from the ground. In addition, generous amounts were allowed for expansion, research and development to meet the industry's future needs. Any company can leave service if future prospects tell it that it can't maintain its market share. As long as ample supplies are secured to meet national needs and a price received which covers the production operations, all legal requirements for valid regulation are met.

Even if the rates don't allow full recovery of "costs" in an individual year, the record shows the cost and revenue figures trend out over a period of time. No reason appears why the Commission should not select a period longer than one year to meet the test for adequacy of revenue set in *Hope*.

The Commission has balanced not only the investor and consumer interests but has given real consideration to industry needs as well. "Pragmatic adjustments" have been made. Petitioners assert, ". . . that the end result in this case cannot be condemned under the Act as unjust and unreasonable. . . ." *(Federal Power Commission* v. *Hope Natural Gas Co.* (1944) 320 U.S. 591,603)

B. THE RELIEF PROVISIONS ESTABLISHED BY THE FPC ARE ADEQUATE AND DEFINITE

The lower court acted improvidently to remand the case and defeat regulation because of supposed defects in the extraordinary relief provision. It is wrong to defeat a whole regulatory scheme on this basis. The relief provision was introduced by the FPC in recognition of the fact that the area method is new and untried. Of course, all problems can neither be anticipated nor provided for. Any solution to a complex problem can have some unfortunate results. The relief provision allows the Commission to make adjustments as needed to insure that undesirable results are avoided.

Allowing for a case by case development of relief standards is proper and within the gambit of proper administrative discretion. *Securities and Exchange Commission* v. *Chenery Corporation* (1947) 332 U.S. 194, 202-203. The Commission did provide some examples to indicate the type of relief available. (R.657d-660d) To require detailed guidelines, as the lower court seems anxious to do, when the area method is in its infancy is premature and would only stunt its growth to full and effective maturity.

C. THERE IS AMPLE MATERIAL IN THE RECORD TO EXPLAIN THE "BTU GAP"

The value of gas is a function of its heating properties. The FPC provided gas of 1000 BTU or less results in a lower price. Gas of over 1050 BTU brings a higher price. No reason beyond delay appears for the producers' objection,

because this gap seems to operate in their favor. Most gas produced lies in the upper range of the gap. (R.651d) If quality deductions were made at that point the revenues received by producers would be reduced. Instead, the FPC in its reasonable discretion allowed the area contract standard of 1000 to be the point of departure for downward adjustments. This action increases the producers' revenues, leaving them in no position to complain validly about the so-called "BTU gap."

D. THE FPC WAS REASONABLE IN SETTING QUALITY STANDARDS

The Tenth Circuit found procedural and substantive defects in the quality standards established by the FPC. The record discloses there is no doubt the producers were aware actual "conditions of delivery" were to be an issue in the case. Ample evidence was introduced on the issue. (See R.746d, 1115d)

The standards are necessary to effective regulation. If only a ceiling price were set producers could easily defeat regulation by setting the high price for low quality gas and thereby secure unwarranted returns.

There are other ways, perhaps better ways, adjustments for quality differentials could be made. The method chosen, however, is based on sufficient material in the record, is not unreasonable and should be affirmed.

E. THE FPC HAS ESTIMATED THE AMOUNT OF QUALITY DEDUCTIONS AND USED THE RESULT IN DETERMINING A PROPER 12% RATE OF RETURN

The Tenth Circuit remanded the case because it felt a determination on the adequacy of the rate of return could not be made. The defect in the record in the court's view was a lack of a finding on the impact of the quality deductions on producer revenues (XII R.54) While a specific finding was not made the lower court has overlooked a considerable body of material in the record which allowed the examiner to make

a reasonable estimate of the deficiencies. (R.245d-247d, 257d) On the basis of this and other evidence, the Commission estimated the amount of the quality discounts. (R.746d, 1115d) These estimated amounts were used as a risk factor and allowances for them were made in the rate of return.

The lower court was in error to require the risk factor be costed rather than included as an element in the rate of return. If they were costed the return rate would be lowered and the substantive change in the regulatory scheme would be almost nil. Furthermore, the distributors, not the producers, generally bear the cost of bringing gas up to standard, so that costing them would be a windfall to producers. The decision to handle deductions as a risk was made upon sufficient evidence. No abuse in discretion can be shown to defeat the Commission's choice of method.

The lower court should have proceeded to pass on the adequacy of the rate of return. Some of the Commission believed it to be "very generous" and petitioners would agree. (R.770d) The record was sufficient to provide an adequate basis for judicial review. The final decision on rate of return of necessity perhaps more than any part of the regulatory process involves judgment, expertise and discretion on the part of the Commission. The rate if in error at all favors the producer and conforms to the fair and reasonable standard imposed by statute and the *Hope* case.

IV.

The Treatment Accorded Refunds by the FPC was Proper and Necessary to Insure the Consumers' Right to Protection Under Section 4(e) of the Natural Gas Act

A. REFUNDS MUST BE ON AN INDIVIDUAL SCHEDULE BASIS TO INSURE EFFECTIVE OPERATION OF AREA PRICING

The Tenth Circuit on rehearing reversed its decision on

the proper refund procedure. The lower court said, "We held that refunds must be on a company-by-company and schedule-by-schedule basis. We are now convinced that such holding was wrong. . . ." (*Skelly Oil Company* v. *Federal Power Commission* (10 Cir. 1967) 375 F.2d 6, 36) The court explained, "This modification of the opinion means that no refund obligation may be imposed for a period in which there is a group revenue deficiency." (375 F.2d at 36)

It is our earnest position that, assuming the area rate making concept has some validity, the lower court was confused or mistaken in its refund ruling. The Tenth Circuit based its holding on this court's treatment of the Phillips Petroleum Company in *Second Phillips*. It should be enough of an answer to point out that *Second Phillips* involved an individual company in a single separate individual cost of service proceeding while the matter now before the Court involves a whole industry. The factors involved in the two different approaches cannot be compared.

In an area proceeding the area rate must establish the maximum permissible price. To allow one company to keep unwarranted and excessive charges because some other inefficient company has not met its revenue requirements is grossly unfair to consumers and a windfall to the efficient producer who is already greatly favored by the area approach. To so hold insures even the most inefficient producer a profit before a consumer of another company's gas can obtain relief from unfairly inflated prices. Such a result does not help the producer who has failed to collect his revenue needs. It does allow retention of monies by firms already amply provided for by the area rate schedule. Such a result seems contrary to the just and fair "end result" test as set out by this court in *Hope*.

Not only does the Tenth Circuit decision conflict with

the area concept which it purports to accept and produce an unfair result, but it seems to conflict with past decisions by this court on similar subjects. The requirement that no refund be made unless all producers, large and small, efficient and inefficient, realize their revenue requirements is contrary to the holding in *Federal Power Commission* v. *Natural Gas Pipeline Co.* (1942) 315 U.S. 575, 590, which clearly stated that constitutionally acceptable regulation does not guarantee a profit. In addition, *Federal Power Commission* v. *Sierra Pacific Power Co.* (1956) 350 U.S. 348, established the principle that failure to make a profit does not in itself justify changes in the regulatory scheme.

In reaching its decision the lower court indicated that its reliance on *Federal Power Commission* v. *Tennesee Gas Transmission Co.* (1962) 371 U.S. 145, was misplaced on the ground that the *Tennesee Gas Transmission Co.* case dealt with zone rights. But that case announced fundamental rules regarding refunds under Section 4(e) of the Natural Gas Act. It should also control here. The lower court's holding would permit individual producers involved in a Section 4 procedure to retain illegal gains representing the portion of rates which exceeds the Commission's just and reasonable area rates, and which were collected subject to refund, in order to balance group revenues with group revenue requirements. This result makes the area method no more than an expanded version of the individual company procedure. Petitioners assert that such a result is not correct.

B. CONSUMER NEED FOR RELIEF IN THE FORM OF REFUNDS NECESSITATES AN AFFIRMANCE OF THE COMMISSION ORDER

It is clear that, unless Congress changes the Natural Gas Act or the U. S. Supreme Court reverses its holding in *First Phillips*, prices paid by the consumers of San Diego and San Francisco will reflect reductions resulting from regulation.

These refunds collected under the terms of Section 4(e) of the Act already approach $40,000,000. If the Tenth Circuit remand is allowed to stand even more refunds will accumulate. This court has accurately pointed out that this form of relief is "somewhat illusory." *Federal Power Commission* v. *Tennesee Gas Transmission Co.* (1962) 371 U.S. 145, 154-155. Consumers tend to be somewhat transient. They move and their refunds are never effected because they cannot be found. Costs of distribution and administration are added and, as in any "trickling down process," there is considerable evaportation.

Given the history of this proceeding, it is a good possibility the refund protection will prove to be completely illusory. The reasons for this statement need not be repeated here in light of the full discussion in the separate opinion in *Second Phillips* 373 U.S., at 323-325. It is all too easy for the producers to manipulate "cost" figures which are only somewhat artificial constructs in the first place to justify partial retention. Moreover, refunds already accumulated when added to those which would pile up if the remand is allowed constitute a staggering sum. Requiring payment of such large cash amounts would surely cause producers to claim financial impairment. The ultimate result if consistent with the history of this proceeding would be further delay and loss to consumers.

In order to secure the consumers' rights in refunds already collected and to prevent any sizeable increases, the order of the Commission and especially the refund provision must be affirmed.

V.

The Court Below Has Given No Reasons for Reversing the Commission's Concurrent Certificate Order

On rehearing, the lower court's *per curiam* opinion *(Skelly*

Oil Co. v. *Federal Power Commission* (10 Cir. 1967) 375 F.2d 6, 36) held that the Commission's concurrent certificate order established the area rate as the proper initial contract price to be permitted in the consolidated certificate proceedings and, since this area rate has been reversed and remanded, the certificate order also must be remanded. The effect of this holding is to reverse the Commission's determination on the question of whether the area rates may be constituted as initial certificate prices without giving any reasons. If the position of the court below prevails, its opinion on this issue would be required before further judicial review would be possible, all to the further delay of this case, which already has become extremely protracted. Petitioners submit that this issue is properly before this court in that the Commission expressed its views on it in Opinion No. 468 and in its concurrent certificate order. (R.668d, R.827d-828d, Section 7) Petitioners urge that this court review this issue and affirm the Commission's determination.

CONCLUSION

The judgment of the Court of Appeals should be reversed and the case remanded to them with instructions to affirm the Federal Power Commission's order in its entirety. All further proceedings in the Permian Basin case should be terminated.

Petitioners believe this solution is the best available despite some minor defects in the order and a rate which is favorable to producers. The consumers of California have have waited long enough for the protection given them by Congress under the Natural Gas Act. On balance, no good purpose can be served by further proceedings. The Federal Power Commission has acted within the limits of its proper

discretion to produce a workable scheme of regulation reasonably fair to all concerned. It should be affirmed.

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Dated: October 18, 1967

Appendix

RELEVANT PARTS OF THE NATURAL GAS ACT

Rates and Charges; Schedules; Suspension of New Rates

Sec. 4. (a) All rates and charges made, demanded, or received by any natural-gas company for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges, shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful.

(b) No natural-gas company shall, with respect to any transportation or sale of natural gas subject to the jurisdiction of the Commission, (1) make or grant any undue preference or advantage to any person or subject any person to any undue prejudice or disadvantage, or (2) maintain any unreasonable difference in rates, charges, service, facilities, or in any other respect, either as between localities or as between classes of service.

(c) Under such rules and regulations as the Commission may prescribe, every natural-gas company shall file with the Commission, within such time (not less than sixty days from the date this act takes effect) and in such form as the Commission may designate, and shall keep open in convenient form and place for public inspection, schedules showing all rates and charges for any transportation or sale subject to the jurisdiction of the Commission, and the classifications, practices, and regulations affecting such rates and charges, together with all contracts which in any manner affect or relate to such rates, charges, classifications, and services.

(d) Unless the Commission otherwise orders, no change shall be made by any natural-gas company in any such rate, charge, classification, or service, or in any rule, regulation,

or contract relating thereto, except after thirty days' notice to the Commission and to the public. Such notice shall be given by filing with the Commission and keeping open for public inspection new schedules stating plainly the change or changes to be made in the schedule or schedules then in force and the time when the change or changes will go into effect. The Commission, for good cause shown, may allow changes to take effect without requiring the thirty days' notice herein provided for by an order specifying the changes so to be made and the time when they shall take effect and the manner in which they shall be filed and published.

(e) Whenever any such new schedule is filed the Commission shall have authority, either upon complaint of any State, municipality, State commission, or gas distributing company or upon its own initiative without complaint, at once, and if it so orders, without answer or formal pleading by the natural-gas company, but upon reasonable notice, to enter upon a hearing concerning the lawfulness of such rate, charge, classification, or service; and, pending such hearing and the decision thereon, the Commission, upon filing with such schedules and delivering to the natural-gas company affected thereby a statement in writing of its reasons for such suspension, may suspend the operation of such schedule and defer the use of such rate, charge, classification, or service, but not for a longer period than five months beyond the time when it would otherwise go into effect; and after full hearings either completed before or after the rate, charge, classification, or service goes into effect, the Commission may make such orders with reference thereto as would be proper in a proceeding initiated after it had become effective. If the proceeding has not been concluded and an order made at the expiration of the suspension period, on motion of the natural-gas company making the filing, the proposed change of rate, charge, classification,

or service shall go into effect. Where increased rates or charges are thus made effective, the Commission may, by order, require the natural-gas company to furnish a bond, to be approved by the Commission, to refund any amounts ordered by the Commission, to keep accurate accounts in detail of all amounts received by reason of such increase, specifying by whom and in whose behalf such amounts were paid, and, upon completion of the hearing and decision, to order such natural-gas company to refund, with interest, the portion of such increased rates or charges by its decision found not justified. At any hearing involving a rate or charge sought to be increased, the burden of proof to show that the increased rate or charge is just and reasonable shall be upon the natural-gas company, and the Commission shall give to the hearing and decision of such questions preference over other questions pending before it and decide the same as speedily as possible. (52 Stat. 822 (1938); 15 U.S.C. § 717c)

Fixing Rates and Charges; Determination of Cost of Production or Transportation

Sec. 5. (a) Whenever the Commission, after a hearing had upon its own motion or upon complaint of any State, municipality, State commission, or gas distributing company, shall find that any rate, charge, or classification demanded, observed, charged, or collected by any natural-gas company in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order; *Provided, however,* That the Commission shall have no power to order

any increase in any rate contained in the currently effective schedule of such natural-gas company on file with the Commission, unless such increase is in accordance with a new schedule filed by such natural-gas company; but the Commission may order a decrease where existing rates are unjust, unduly discriminatory, preferential, otherwise unlawful, or are not the lowest reasonable rates.

(b) The Commission upon its own motion, or upon the request of any State commission, whenever it can do so without prejudice to the efficient and proper conduct of its affairs, may investigate and determine the cost of the production or transportation of natural gas by a natural-gas company in cases where the Commission has no authority to establish a rate governing the transportation or sale of such natural gas. (52 Stat. 823 (1938); 15 U.S.C. § 717d)

Construction, extension, or abandonment of facilities; certificate of convenience and necessity; condemnation proceedings

Sec. 7. (a) Whenever the Commission, after notice and opportunity for hearing, finds such action necessary or desirable in the public interest, it may by order direct a natural-gas company to extend or improve its transportation facilities, to establish physical connection of its transportation facilities with the facilities of, and sell natural gas to, any person or municipality engaged or legally authorized to engage in the local distribution of natural or artificial gas to the public, and for such purpose to extend its transportation facilities to communities immediately adjacent to such facilities or to territory served by such natural-gas company, if the Commission finds that no undue burden will be placed upon such natural-gas company thereby: *Provided*, That the Commission shall have no authority to compel the enlargement of transportation facilities for such purposes, or to compel such natural-gas company to establish physical

connection or sell natural gas when to do so would impair its ability to render adequate service to its customers.

(b) No natural-gas company shall abandon all or any portion of its facilities subject to the jurisdiction of the Commission, or any service rendered by means of such facilities, without the permission and approval of the Commission first had and obtained, after due hearing, and a finding by the Commission that the available supply of natural gas is depleted to the extent that the continuance of service is unwarranted, or that the present or future public convenience or necessity permit such abandonment.

(c) No natural-gas company or person which will be a natural-gas company upon completion of any proposed construction or extension shall engage in the transportation or sale of natural gas, subject to the jurisdiction of the Commission, or undertake the construction or extension of any facilities therefor, or acquire or operate any such facilities or extensions thereof, unless there is in force with respect to such natural-gas company a certificate of public convenience and necessity issued by the Commission authorizing such acts or operations: *Provided, however,* That if any such natural-gas company or predecessor in interest was bona fide engaged in transportation or sale of natural gas, subject to the jurisdiction of the Commission, on February 7, 1942, over the route or routes or within the area for which application is made and has so operated since that time, the Commission shall issue such certificate without requiring further proof that public convenience and necessity will be served by such operation, and without further proceedings, if application for such certificate is made to the Commission within ninety days after February 7, 1942. Pending the determination of any such application, the continuance of such operation shall be lawful.

In all other cases the Commission shall set the matter

for hearing and shall give such reasonable notice of the hearing thereon to all interested persons as in its judgment may be necessary under rules and regulations to be prescribed by the Commission; and the application shall be decided in accordance with the procedure provided in subsection (e) of this section and such certificate shall be issued or denied accordingly: *Provided, however,* That the Commission may issue a temporary certificate in cases of emergency, to assure maintenance of adequate service or to serve particular customers, without notice or hearing, pending the determination of an application for a certificate, and may by regulation exempt from the requirements of this section temporary acts or operations for which the issuance of a certificate will not be required in the public interest.

(d) Application for certificates shall be made in writing to the Commission, be verified under oath, and shall be in such form, contain such information, and notice thereof shall be served upon such interested parties and in such manner as the Commission shall, by regulation, require.

(e) Except in the cases governed by the provisos contained in subsection (c) of this section, a certificate shall be issued to any qualified applicant therefore, authorizing the whole or any part of the operation, sale, service, construction, extension, or acquisition covered by the application, if it is found that the applicant is able and willing properly to do the acts and to perform the service proposed and to conform to the provisions of this chapter and the requirements, rules, and regulations of the Commission thereunder, and that the proposed service, sale, operation, construction, extension, or acquisition, to the extent authorized by the certificate, is or will be required by the present or future public convenience and necessity; otherwise such application shall be denied. The Commission shall have the power to attach to the issuance of the certificate and

to the exercise of the rights granted thereunder such reasonable terms and conditions as the public convenience and necessity may require.

(f) The Commission, after a hearing had upon its own motion or upon application, may determine the service area to which each authorization under this section is to be limited. Within such service area as determined by the Commission a natural-gas company may enlarge or extend its facilities for the purpose of supplying increased market demands in such service area without further authorization.

(g) Nothing contained in this section shall be construed as a limitation upon the power of the Commission to grant certificates of public convenience and necessity for service of an area already being served by another natural-gas company.

(h) When any holder of a certificate of public convenience and necessity cannot acquire by contract, or is unable to agree with the owner of property to the compensation to be paid for, the necessary right-of-way to construct, operate and maintain a pipe line or pipe lines for the transportation of natural gas, and the necessary land or other property, in addition to right-of-way, for the location of compressor stations, pressure apparatus, or other stations or equipment necessary to the proper operation of such pipe line or pipe lines, it may acquire the same by the exercise of the right of eminent domain in the district court of the United States for the district in which such property may be located, or in the State courts. The practice and procedure in any action or proceeding for that purpose in the district court of the United States shall conform as nearly as may be with the practice and procedure in similar action or proceeding in the courts of the State where the property is situated: *Provided,* That the United States district courts shall only have jurisdiction of cases when the amount claimed by the

owner of the property to be condemn
(52 Stat. 824 (1938); 15 U.S.C. § 717f, as

nned exceeds $3,000.
as amended.)

BRIEF AMICUS CURIAE

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JOHN F. DAVIS, C

Nos. 261, 262, 266, and 388

IN THE

Supreme Court of the United States

OCTOBER TERM, 1967

THE PERMIAN BASIN AREA RATE CASES

On Writs of Certiorari to the United States Court of Appeals for the Tenth Circuit

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BRIEF AMICUS CURIAE FOR PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK

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BRIEF AMICUS CURIAE FOR PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK

INTEREST OF AMICUS CURIAE

The Public Service Commission of the State of New York is a state agency whose duties include regulating the rates and charges for the sale of natural gas by gas distribution companies to ultimate consumers in the State of New York. Virtually all of the gas consumed within the State originates in producing areas outside of the State—primarily in the Gulf Coast area

of Texas and Louisiana—and both the price at which the producer sells the gas to the pipeline in the field and the price at which the pipeline resells the gas to distribution companies serving New York consumers are subject to regulation by the Federal Power Commission.

Because the economic burden of higher producer rates is borne by the ultimate consumer, the New York Commission has played an active role in producer proceedings before the Federal Power Commission throughout the entire period since 1954, when this Court directed the Federal Power Commission to exercise the jurisdiction over producer sales given it by the Natural Gas Act of 1938. The purpose in such participation has been to assist the FPC in establishing just and reasonable rates for producer sales (and also in establishing a system or method of fixing just and reasonable rates for such sales), to the end that the consumer would be afforded "a complete, permanent and effective bond of protection from excessive rates and charges," *Atlantic Refining Co.* v. *Public Service Commission of New York,* 360 U.S. 378 at 388 (1959).

INTRODUCTION

Seven years ago, in *Phillips Petroleum Co.* (second *Phillips*), Op. 338, 24 FPC 537, the Federal Power Commission determined that it would abandon the individual-company method of producer rate regulation —a method then on the verge of effective realization —and would substitute therefor an industry-wide method, under which uniform rates for an entire producing area would be fixed. Because we believed that this change in approach, though not necessarily inappropriate *per se,* would cause a substantial delay in

the establishment of just and reasonable rates, we appealed the Commission's determination. The Commission defended its action with the contention that its new area rate-making method could and would be in operation "by the early part of 1964, no later than the anticipated decision-date in [second *Phillips*] if it were remanded by this Court."[1] Relying on this representation, the Court affirmed the Commission, *Wisconsin* v. *F.P.C.*, 373 U.S. 294 at 313-14; compare 373 U.S. at 317, 333 (dissenting opinion).

The present appeals bring before the Court the result of the Commission's first, and to date only, determination of just and reasonable area rates. It is the purpose of this brief to focus on certain key issues from the standpoint of the consumer interest.

ARGUMENT

I. The Commission Has Power To Fix Rates for Field Sales of Natural Gas on an Area Basis

While we disagree with the Commission's conclusions (a) that regulation of producer rates on an industry or area-wide basis is required by the nature of the industry and (b) that, in any event, the area-wide basis is preferable to the individual-company basis, certainly at this juncture—with the individual-company method having been discarded in second *Phillips* and with the area-wide method now at the point of effectuation—we believe that the interests of consumers would best be served by affirmance of the Commission's use of the area method.

From a practical standpoint, delay in setting just and reasonable producer rates has worked to the injury

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[1] Brief for Federal Power Commission, p. 47, *Wisconsin* v. *F.P.C.*, 373 U.S. 294.

of the consumer: since 1954, when this Court directed the Commission to fix producer rates, the average price charged by producers for sales in interstate commerce has climbed from less than 10¢ per Mcf to over 17¢ per Mcf, and, as the present case suggests, the Commission is apparently influenced, when it finally does set just and reasonable rates, by the levels to which prices have risen.

With respect to the delay in effectuation of the area rate-making program, we would note that the estimates Commission counsel gave this Court in second *Phillips* (see note 1, *supra*) have proven grossly inaccurate, and we are dismayed that as of today—over seven years after area rates were originally proposed—the Commission has set rates for only one area, accounting for less than 12% of the gas sold in interstate commerce. Further, as shown in the appendix to the Brief Amicus for the Associated Gas Distributors Group, the area proceedings instituted subsequent to *Permian* are taking even longer to reach decision than *Permian,* notwithstanding the Commission's assurance that once the trail had been blazed in *Permian,* the subsequent cases could be heard and decided more expeditiously.

II. The Area Rates Fixed by the Commission May Not Produce an Excessive Return to the Regulated Entity

Whatever the *unit* of regulation, whether individual-company or the entire industry, it is clear that the Federal Power Commission's obligation is to fix "just and reasonable rates," which, as the Commission acknowledged both in its argument to this Court in second *Phillips* and in its decision here under review, means rates that are fixed on the basis of the *costs* of the regulated entity—i.e., rates that will produce revenues which cover, but do not exceed, all of the costs of pro-

viding the regulated service, including a reasonable return on the investment necessary to provide the service.

This is, of course, the teaching of this Court's historic decision in *F.P.C.* v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944); yet, while not disputing the force of *Hope*, the Commission has failed, as *amicus* Philadelphia Electric Company properly points out, to make the requisite cost determination. Specifically, in the order here under review, the Commission imputed to casinghead gas the unit costs it found for the admittedly higher-cost gas-well gas, thereby improperly inflating the "cost" base on which it fixed rates. This error clearly provided a windfall for the Permian producers at the expense of the consumers, and while it has not been challenged here by any of the consumer groups directly affected, we believe that the Commission's improper inflation of costs should not be approved by this Court. Our concern on this point is heightened by the fact that should this improper inflation of costs be repeated in the Southern Louisiana area rate proceeding, as the examiner there has recently recommended, New York consumers would be forced to pay excessive and unreasonable charges.

III. The Area Rates Fixed by the Commission Should Remain in Effect Until Evidence Is Adduced To Demonstrate That Such Rates Are No Longer Just and Reasonable

Having spent five years in determining the just and reasonable rates for Permian Basin producers—eleven years if the earlier 1954-60 second *Phillips* period is taken into account—the Commission ruled that the rates it fixed need remain in effect for only 28 months, until January 1, 1968, after which date the producers could file for and place in effect increased rates, well in excess of the rates fixed as just and reasonable by the

Commission, *without making any showing that costs had increased or that revenues had declined subsequent to the closing of the record below.* Given the Commission's probable scheduling of hearings, it could be well into the 1970's before the Commission would, in a second *Permian* proceeding, catch up with the increased rates and be able to remedy in part, through the ordering of refunds, the damage done to the consumer by the higher rates.

Thus, the length of time that the rates fixed by the Commission are to remain in effect—the so-called "moratorium" issue—is of crucial importance to the Commission's program of area rate-making (or indeed to any system of rate regulation),[2] though the issue as presented by the parties to this appeal presents less than the total picture. Specifically, we think it clear that the 28-month moratorium adopted by the Commission in *Permian* is far too brief to provide adequate protection to the consumer, and we have accordingly urged the Commission, in the pending Southern Louisiana proceeding, to provide that the rates fixed by it shall remain in effect until modified by further Commission order, to be entered only upon a showing of changed circumstances. In its brief to this Court (pp. 74-75, 74 n. 48), the Commission concedes not only that it has the power to provide that the rates prescribed by it in the instant proceeding "remain in force until modified by further Commission order" but that it "would have been warranted" in so providing here. In this connection we would point out that the major portion of the cost of flowing gas—exploration and development, return, and depreciation—will not vary appreciably in the future for the gas

[2] The Commission correctly notes that this issue "is important for other area rate proceedings," Brief for FPC, p. 69 n. 44.

for which rates were set by the *Permian* order. The only element of cost-of-service which might vary—operating expense—is relatively minor, so that if the Commission correctly determined costs, there should be little need for subsequent rate change.

CONCLUSION

The Federal Power Commission's much-delayed program of producer rate regulation has, for the consumer, been too little and too late. After years of no effective regulation during which the Commission permitted gas prices to leap from plateau to higher plateau, the Commission appears inclined, on finally effecting regulation, to ratify in large part the high prices produced by delay. Nonetheless, and subject to correction of the errors noted herein, we support the Commission's order on the unhappy ground that little is better than nothing and late is better than never. We believe it may be appropriate, however, for this Court to remind the Commission of the power it has, if it will but use it, to afford real and meaningful protection to the consumer.

Respectfully submitted,

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NOV 20 1967

JOHN F. DAVIS, CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1967

Nos. 90, *et al.*

THE PERMIAN BASIN AREA RATE CASES

On Writs of Certiorari to the United States Court of Appeals for the Tenth Circuit

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1967

Nos. 90, *et al.*

THE PERMIAN BASIN AREA RATE CASES

On Writs of Certiorari to the United States Court of Appeals for the Tenth Circuit

---

BRIEF FOR PRODUCER RESPONDENTS IN NOS. 261 AND 262 SUPPORTING DECISION OF THE COURT BELOW

PRELIMINARY STATEMENT

By order entered October 9, 1967, the Court issued writs of certiorari in No. 261 (City and County of San Francisco) and No. 262 (City of San Diego) (referred to collectively herein as Petitioners) and it is to the joint brief of those Petitioners that we respond herein. We reply to the unwarranted allegations of delay and we respond to the points raised concerning the

rate-determination and the refund questions, referring to our prior brief wherever possible.[1]

The "Opinions Below", "Jurisdiction", "Statutes Involved", "Questions Presented" and "Counterstatement", are set forth in our prior brief (P. Res. Br., pp. 2-9).

ARGUMENT

I. The Charge of Producer Delay Is Unfair and Unfounded

Petitioners argue that elimination of delay requires reversing the Court of Appeals even if its basic reasoning is correct. This novel concept would sacrifice legal standards solely for expedition. Indeed, there was no delay; time consumed for this landmark proceeding was wholly warranted. No one questions that Commission regulation of producer prices has been time consuming. Producer efforts and desires to expedite proceedings so as to obtain rate stability and predictability have been recognized. "Delays" cited by Petitioners have resulted from the nature and size of the proceedings, uncertainty by all parties as to substantive criteria to be used, and absence of adequate notice as to issues upon which evidence should be introduced. These causes contributed to the incompleteness of findings and use of materials outside the record to fix rates, necessitating the remand ordered below.

We have shown the limited scope of the required remand (P. Res. Br., pp. 120-122). The major findings of the Commission, including its determination as to area costs, were not disturbed. The proceedings were merely remanded for completion of the Commission's

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[1]Brief for Producer Respondents Supporting Decision of Court Below, Dated October 9, 1967, referred to as "P. Res. Br."

statutory duty. In an effort to expedite the limited proceeding required by the remand, on May 1, 1967, some of these Respondents filed with the Commission a "Petition for Convening of Conference and Hearing to Determine Issues on Remand."

Petitioners urge that errors depriving producers of their right to just and reasonable rates can be adjusted in subsequent proceedings, presumably in special exemption proceedings (Pet. Br., pp. 15-18). Individual special exemption proceedings cannot be substituted for group area rate proceedings. The time consumed by numerous special exemption proceedings would far exceed the brief period required for Commission completion of its findings as required on the remand.

Contrary to the allegations of Petitioners, the Examiner (R. 105d-107d) and the Commission (R. 531d) expressly found that Producer Respondents have cooperated diligently in efforts to expedite the proceeding and obtain an early decision. Just as their allegations of delay are contradicted by the record, Petitioners' allegations that delay has injured consumers and benefited producers are also contrary to fact. As clearly shown by our brief, the producers' test year area cost found by the Commission substantially exceeds El Paso Natural Gas Company's test year area cost of purchased gas passed on to ultimate consumers (P. Res. Br., pp. 73-74).[2] Petitioners do not cite any record data purporting to show consumer injury resulting from the delay; rather, the record-supported data in our earlier brief showing that consumers have been receiving gas at prices *below* the area cost levels found

[2] It is noteworthy that for the test year, El Paso had the highest purchased gas cost of any of the pipelines purchasing Permian gas.

by the Commission is conveniently ignored (P. Res. Br. pp. 48-49).[3]

Petitioners erroneously cite *Second Phillips* as approving Commission avoidance of regulatory duties with the result that consumers have been deprived of reasonable rates (Pet. Br., p. 9). Here again, Petitioners conveniently overlook that, as recognized by this Court, the rates collected by Phillips were inadequate to recoup the cost of service found by the Commission.[4] Consequently, consumer protection was not sacrificed. The facts shown in the *Phillips* record and the record here are that, where alleged delay has resulted in producer revenues not equaling producer costs, injury flowing from such "delay" has been borne exclusively by producers and has resulted in consumers paying below-cost rates. The limited remand would *not* carry with it a risk of consumer injury and specifically *cannot* result in consumers paying more than the Permian Basin area revenue requirements.

II. The Court Below Correctly Concluded That the Commission's Rate Findings Were Incomplete

Petitioners argue that the record was adequate for judicial review and that the court below erred in its remand order (Pet. Br., pp. 16-20). Such argument

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[3] Petitioners' argument that, prior to this Court's decision in *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944), Producer Respondents united to delay Commission proceedings is absurd. (Pet. Br., p. 10). As the Commission properly recognizes (FPC Br., p. 44, n. 25) *Hope* was a pipeline case decided long before producer regulation became an issue. Petitioners also ignore the fact that the area rate method was instituted on the Commission's own motion and *not* at the request of producers.

[4] *Wisconsin* v. *Federal Power Commission*, 373 U.S. 294, 305 (1963).

reflects substantial misapprehension of what the Commission did and what is contained in the record.

It is first argued that the area price meets the requirements of *Hope* because the Commission meant by its fair relationship test that the rates would provide the required revenue and attract capital to the industry as a unit[5] (Pet. Br. p. 17). Not only is there an absence of any indication that the Commission has ascribed such meaning to its fair relationship test but also its Opinion on rehearing and its brief make clear that it could not possibly ascertain the revenues its order would yield. Thus, the Commission could not determine the amount of the downward quality adjustments.

Contrary to the record, Petitioners argue that the Commission failed to take account of (1) the federal income tax advantages received by gas producers, and (2) the incidental revenues received from the sale of non-jurisdictional liquids (Pet. Br., p. 17).

Any alleged federal income tax advantages can only be considered in the Commission's determination whether to include a cost allowance for federal income tax in its cost determinations for both old and new gas. The Commission did not include an allowance for federal income tax in either of those cost determinations. Consequently, any alleged federal income tax advantages were actually considered by the Commission in reaching its cost determinations.

---

[5] We invite attention to the inconsistency between insistence upon considering the group as a whole for the purpose of determining area costs and the later contention that the group be ignored in determining refund liability and that refunds be determined solely on an individual rate schedule basis regardless of the group revenue deficiency.

As to producers' revenues from the sale of non-jurisdictional liquids, Petitioners' statement that the Commission did not take them into account is simply not true. In its cost determinations, all of the costs attributable to non-jurisdictional liquids were expressly excluded by the Commission (R. 579d; 586d-590d). After excluding these non-jurisdictional costs from its cost determinations for jurisdictional gas, the Commission consistently excluded the corresponding revenues from the sale of the non-jurisdictional liquids. Hence, the Commission did "take account of" the revenues from liquids in its overall determination of the jurisdictional costs and revenues.

Petitioners seek to excuse the test-year imbalance by arguing that even if producer rates do not allow recovery of costs in an individual year, "the records show the cost and revenue figures trend out over a period of time" (Pet. Br., p. 17).[6] It is indeed obvious why Petitioners do not provide a record citation for this assertion. Aside from this unsupported attack on the "test year" concept, the history of producer regulation has shown that natural gas has been consistently underpriced. *Phillips Petroleum Co.*, 24 FPC 537, 547 (1960). This Court observed in *Second Phillips* that the record before it did not ". . . paint a picture of the public interest sacrificed on the alter of private profit" (373 U.S. at 312).

Finally, Petitioners allege that the court below overlooked ". . . a considerable body of material in the record which allowed the Examiner to make a reasonable estimate of the [quality] deficiencies" (Pet. Br.,

[6] This argument is internally contradictory in that it assumes that revenues will increase while costs remain constant—a logical impossibility.

pp. 19-20). Again, this is contrary to the record. The Examiner clearly stated (R. 256d):

> "This record does not permit the determination of a complete set of quality and value differentials."

The record references relied upon by Petitioners lend no support for their position. In fact, they reflect that the Examiner concluded that the record would require the Commission to conduct further proceedings to establish complete quality differentials (R. 257d).

In sum, these Petitioners apparently conceive an area rate method as devoid of substantive standards and as not requiring agency findings upon record evidence. Such cannot be. This Court has held that the end result test is "not a standard so vague and devoid of meaning as to render judicial review a perfunctory process," but that it is "a standard of finance resting on stubborn facts." *Colorado Interstate Gas Co.* v. *Federal Power Commission*, 324 U.S. 581, 605 (1945). This Court also recently noted the means by which findings as to aggregate requirements are properly and specifically translated into rate levels, even where group methods are used. *Chicago & N.W.R. Co.* v. *Atchison, T. & S.R. Co.*, 387 U.S. 326 (1967). This Court further has held that under Section 19(b) of the Natural Gas Act, reviewing courts must know what the findings are before they can be accorded weight; that absence of required findings can "only clog the administration function and add to the delays in ratemaking"; and that "courts cannot perform the function which Congress assigned to them in absence of adequate findings and are not authorized under Section 19(b) to make findings and substitute them for those of the Commission" *Colorado-Wyoming Gas Co.* v. *Federal Power Commission*, 324 U.S. 626, 634 (1945).

Here, there is no record basis for the Commission rate design; the rate of return and cost coverage are unknowns; and only the Commission can supply the missing findings. Beyond this, the result urged by these Petitioners could only be a structure of rates generating revenues below the area revenue requirements conclusively shown to exist by the findings the Commission did make. The adverse effects of such a result upon producers' financial ability to search for and devlop new supplies, or even to maintain past delivery levels, are obvious "stubborn facts." Decline in producer deliveries also could but have an escalating effect on consumer rates in San Francisco and San Diego because of the resultant inability of pipelines and distribution companies to maintain economies flowing from present high load factors.[7]

A system of regulation in which not even an attempt is made to prescribe rates consistent with findings as to revenue requirements would lead inevitably to these ultimate results.

III. The Court Below Correcfly Held That Refunds May Be Required Only When Group Revenues Exceed Group Revenue Requirements.

Petitioners argue that refunds must be determined on an "individual schedule" basis rather than on a group basis as required by the Court of Appeals (Pet. Br., pp. 20-22). Our brief fully responded to this contention (P. Res. Br., pp. 69-86). We here respond only to the suggestion that *Second Phillips* is not in point

[7] For a discussion of the significance of the correlation between load factors and costs, see *Lynchburg Gas Co.* v. *Federal Power Commission*, 336 F.2d 942 (D.C. Cir. 1964) and *Colorado-Wyoming Gas Co.* v. *Federal Power Commission*, 324 U.S. 626 (1945).

because it dealt with an individual company rather than a group.[8]

The instant case, of course, is one of first impression both to the Commission and to the reviewing courts. Judicial decision must, therefore, be grounded on application of statutory law as guided by principles enunciated in analogous prior cases. In *Second Phillips* the Commission reviewed the rates of the then largest seller of natural gas in the United States.[9] Phillips' jurisdictional sales were represented by hundreds of rate schedules on file with the Commission.[10] As here, some of the rates among Phillips' Section 4(e) dockets were in excess of the average cost level, although in sum Phillips' rates produced less revenue than the cost of service.[11] The Commission's action terminating all consolidated Section 4(e) dockets without refund requirement was affirmed by this Court in *Second Phillips.*[12]

The parallel between Phillips' numerous Section 4(e) dockets at varying rate levels and those of the

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[8] Petitioners follow this argument with an abrupt reversal, stating that *Federal Power Commission* v. *Tennessee Gas Transmission Co.*, 371 U.S. 145 (1962) announced "fundamental rules" which "should also control here" (Pet. Br. p. 22). We do not understand how *Tennessee Gas* can avoid the Petitioners' stigma of being an individual company case, nor do we understand how it enunciates fundamental rules while *Second Phillips* does not. In our earlier brief we give full consideration to *Tennessee Gas.* (P. Res. Br., pp. 78-81)

[9] *Phillips Petroleum Co.*, 24 FPC 537, 541 (1960).

[10] *Id.*, at 575.

[11] *Id.*, at 1009.

[12] *Wisconsin* v. *Federal Power Commission*, 373 U.S. 294, 305 (1963).

group in the Permian Basin Area is obvious. The legal principle established by *Second Phillips* is that the regulated *entity* cannot properly be compelled to make refunds unless the entity's revenues exceed its revenue requirements. The shift in methodology from individual company ratemaking to group ratemaking, in which the individual company is replaced as the regulated entity by area producers as a group, does not render that principle inapplicable. Nor does the shift require or permit a retreat from the group revenue test to an individual rate schedule revenue test; rather the revenue test for refund purposes must move to a group basis to be in step with the composite group cost criteria used by the Commission.

Petitioners' refund argument assumes that the Commission decision on remand will result in "unwarranted and excessive charges" and "illegal gains" by producers. This assumption is based on further but unarticulated assumptions that: (1) unless rate reductions and refunds are ordered, even though area revenues of *all* producers are reduced *below* the area cost found by the Commission, producers will recoup "illegal gains" and (2) the remand ordered below so restricts Commission discretion that its decision on remand must permit retention by producers of "illegal gains". In its *Second Phillips* decision this Court followed an unbroken line of authority in refusing to condemn the area method and prohibit area rate hearings on the basis of speculative allegations that the new procedures would necessarily produce unlawful and unreasonable results. This Court has uniformly refused to review speculations as to results of future regulatory proceedings. *Cf., Eccles* v. *Peoples Bank,* 333 U.S. 426 (1948) and *Federal Power Commission* v. *Metropolitan Edison Co.,* 304 U.S. 375 (1938).

Petitioners' arguments that the remand for further findings and orders respecting rate reductions and refunds must *now* be condemned as necessarily requiring unlawful results are unsupported. Rather, it must be presumed that the Commission decision will be productive of full consumer protection and of lawful and fair results, because, *inter alia,* the opinion below requires that rates be reduced and refunds ordered where necessary to bring area revenues down to the area revenue requirements level found by the Commission and requires that refund amounts be equitably apportioned. It cannot be assumed that the Commission will fail equitably to apportion refund amounts or order the rate reductions and refunds necessary to bring area revenues down to the area revenue requirements levels found by it. Thus, Petitioners have not shown and cannot show that Commission action under the decision below will deprive consumers of their right to just and reasonable rates or result in "illegal gains" to producers.[13]

CONCLUSION

The brief for Petitioners, though riddled with the inaccuracies which we have pointed out, is remarkable for its candor (Pet. Br., p. 10):

> "Even if one assumed that a good portion of their [producers] current arguments are correct, the loss to the companies is small when compared to that borne by consumers in the absence of regulation."

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[13] Contrary to Petitioners' argument misreading *Federal Power Commission* v. *Tennessee Gas Transmission Co.*, 371 U.S. 145 (1962), the risk of "illegal gains" and consumer injury cited in that case is absent here because the court below required equitable and nondiscriminatory elimination of *all* excessive area revenues, and pipeline area gas purchase costs reflected in consumer rates will *not* exceed Commission determined area revenue requirements.

As we submit this cause in the belief that this Court will render its decision on the merits rather than according to the identity of the parties, we suggest that the brief for Petitioners is entitled to little weight.

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PETITIONER'S

REPLY

BRIEF

NOV 20 1967

JOHN F. DAVIS, CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1967

"PERMIAN BASIN AREA RATE CASES"
Nos. 90, 95, 98, 99, 100, 101, 102, 105,
117, 181, 261, 262, 266, 388

On Writs of Certiorari to the United States Court of Appeals for the Tenth Circuit

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REPLY BRIEF OF SUN OIL COMPANY TO PETITIONERS' BRIEF IN NOS. 261 AND 262

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1967

"PERMIAN BASIN AREA RATE CASES"
Nos. 90, 95, 98, 99, 100, 101, 102, 105, 117, 181, 261, 262, 266, 388

On Writs of Certiorari to the United States Court of Appeals for the Tenth Circuit

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REPLY BRIEF OF SUN OIL COMPANY TO PETITIONERS' BRIEF IN NOS. 261 AND 262

INTRODUCTION

Sun Oil Company (Sun) is Petitioner in No. 99 of these proceedings and Respondent in Nos. 100, 102, 117, 181, 261 and 262. On October 9, 1967 Sun filed its Brief with respect to all cases except 261 and 262. By order issued October 9, 1967 certiorari was granted in Nos. 261 and 262. A joint brief was filed on October 18, 1967 by City of San Diego and the City and County of San Francisco, Petitioners respectively in Nos. 261 and 262.[1] This reply brief is directed to that joint brief.

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[1] Hereinafter referred to as "the joint brief" or "J. Br." Sun's initial brief will be sometimes referred to as "Sun Br." and the Federal Power Commission's brief as "Comm. Br."

ARGUMENT

The joint brief for the most part is a restatement of the arguments presented by the Federal Power Commission ("Commission") in defense of its Opinion No. 468 and collateral orders. Accordingly, Sun relies on its initial brief in order to avoid repetition. Nevertheless, the joint brief does present several arguments to which Sun considers that an answer is warranted in view of the emphasis the joint brief places on such arguments, and the fact that the joint brief urges them as if summarily dispositive of all issues that have been so extensively briefed by the parties in these cases.

Delay

The joint brief places great stress on the delay that would result from a remand (J. Br. 8-12)[2] and argues that the "leering beast named 'delay' " is a "stratagem" of the producers to defeat effective regulation (J. Br. 9, 10). Thus the brief suggests that notwithstanding the merits of the appeal, the Court should affirm the Commission in its entirety (J. Br. 10).

Sun submits that such argument is unworthy. Avoidance of delay of a remand is an argument available to all those who superficially seek to affirm the tribunal before which a matter was initially tried. Even more important however, the issues Sun poses cannot be disposed of so easily. These cases involve far more than regulating the natural gas producing industry by the Federal Power Commission—even as important as regulation is to that industry and that industry is to the

[2] See also Briefs *amicus curiae* of Associated Gas Distributors Group, pp. 10-11 and Public Service Commission of the State of New York, p. 4.

nation. Fundamental to these proceedings are the constitutional limitations of all economic regulation of business. Furthermore, there is to be determined the effect that should be given to the phrase contained in many regulatory statutes—that each rate of any regulated entity shall be just and reasonable—when a regulatory body seeks to institute a system of group regulation. Additionally, these proceedings involve important due process questions.

Sun submits that its initial brief (Sun Br. 61-65) describes a logical pattern for reconciling individual interests with group regulation—a pattern which is well supported by many clear holdings of this Court. This pattern should have been readily apparent to the Commission prior to its decision. It certainly has been pointed out many times by Sun at various stages of the proceeding and could have been verified by the Commission's legal staff. In addition, the Commission had the opportunity to consult with other Federal regulatory agencies as to their solution of similar problems.

Nevertheless, as shown in Sun's initial brief, the Commission failed properly to analyze and apply the law governing group ratemaking (pp. 75-77), to gather or use the necessary evidence (Sun Br. 79-87, 105-110), to afford the due process of adequate cross-examination and rebuttal (Sun Br. 87-98), and to make the required findings (Sun Br. 99-101, 103, 107). Sun submits that these are constitutional minimums, and in the words of Justice Cardozo speaking for this Court in *Ohio Bell Telephone Co.* v. *Public Utilities Commission of Ohio,* 301 U.S. 292 (1937), when such constitutional restraints have been neglected or ignored, "[t]here can be no

compromise on the footing of convenience or expediency, or because of a natural desire to be rid of harassing delay * * *'' (301 U.S. at 304-305).

No Guaranteed Profit

In the same vein as its argument on delay, the joint brief seeks to impress upon this Court that it may rationalize an affirmance of Opinion No. 468 by use of the regulatory aphorism that regulation does not guarantee a profit. Were it not for the constant repetition of this theme (J. Br. 15, 16, 21, 22), and the citation of several important cases as its source (J. Br. 15-16), the statement would not merit an answer. As it is, the reply to this proposition requires little more than a reading of the relevant context of the cases cited at the point where the phrase is used, *i.e., Federal Power Commission* v. *Natural Gas Pipe Line Company*, 315 U.S. 575, 590 (1942); *Federal Power Commission* v. *Hope Natural Gas Company*, 320 U.S. 591, 603 (1944).

In context, it is submitted that the above citations do not justify fixing rates that produce no profit, but instead wholly support Sun's position that rates fixed under the Natural Gas Act must as a minimum allow the regulated company the opportunity to recover its operating expenses and capital charges—assuming, that those expenses and charges are prudently incurred and that the rate that would allow their recovery may be charged within the limits of competition (Sun Br. 48-55). Thus, in *Natural Gas Pipeline*, this Court's statement that "regulation does not insure that the business shall produce net revenues," followed immediately the Court's holding that if excess capacity were used and useful, it could be included in the rate base and maintenance on it could be included in operating

expenses, "having in view the character of the business to secure a fair return upon the rate base provided the business is capable of earning it" (315 U.S. at 590). Regarding the reference to *Hope,* the citation in context is as follows:

> "The rate-making process under the Act, i.e., the fixing of 'just and reasonable' rates, involves a balancing of the interests. Thus, we stated in the Natural Gas Pipeline Co. Case that 'regulation does not insure that the business shall produce net revenues.' 315 U.S. p. 590. But such considerations aside, the investor interest has a legitimate concern with the financial integrity of the company whose rates are being regulated. From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. Cf. Chicago & G. T. R. Co. v. Wellman, 143 U.S. 339, 345, 346 * * *" (320 U.S. at 603)[3]

Leaving the Business

A third proposition that the joint brief erroneously emphasizes is that "The high cost producer who proves unable to operate under the rate scheme is free to leave the industry" (J. Br. 15; see also J. Br. 17).

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[3] As pointed out in Sun's brief (Sun Br. 49-50), the Commission's brief (Comm. Br. 39-40), in the same fashion as the joint brief, ignores this Court's statement of an investor's "legitimate concern" with a regulated company's financial integrity. Thus the Commission's brief emphasizes the reference to balancing consumer and investor interests as support for "any ratemaking method it reasonably deems adapted to the regulatory purpose," but wholly ignores the legitimate investor interest in the regulated company recovering its operating expenses and capital charges, as stated both in *Hope* and in the concurrence to *Natural Gas Pipeline,* 315 U.S. at 607.

This statement is made without citation and is refuted by the abandonment provision of Section 7(b) of the Natural Gas Act, 15 U.S.C. § 717f(b), which was specifically held to apply to producers in *Sunray Mid-Continent Oil Company* v. *Federal Power Commission*, 364 U.S. 137 (1960). Sun's initial brief (Sun Br. 41-45) points out that in accordance with this Court's holding in *Bowles* v. *Willingham*, 321 U.S. 503, 517 (1944), the abandonment section is one of the factors which from a constitutional standpoint requires that consideration be given to the individual in fixing rates under the Natural Gas Act. Sun submits that the categorical statement in the joint brief that producers are free to leave the business is erroneous and in no way provides a basis for avoiding this important limitation on group ratemaking by the Commission.

CONCLUSION

Sun submits that the delay which may be caused by a remand does not warrant ignoring the important issues herein, and the joint brief provides no valid basis for affirming the Commission's erroneous Opinion No. 468,

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November 20, 1967



PETITIONER'S BRIEF

RESPONDENT'S BRIEF

FILED
OCT 9 1967
JOHN F. DAVIS, CLERK

Nos. 90, 95, 98-102, 105, 117, 181, 261, 262, 266, 388

IN THE

Supreme Court of the United States

OCTOBER TERM, 1967

THE PERMIAN BASIN AREA RATE CASES

On Writs of Certiorari to the United States Court of Appeals for the Tenth Circuit

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BRIEF FOR STANDARD OIL COMPANY OF TEXAS, A DIVISION OF CHEVRON OIL COMPANY, PETITIONER IN NO. 266 AND RESPONDENT IN NOS. 117, ET AL.

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IN THE

Supreme Court of the United States

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Nos. 90, 95, 98-102, 105, 117,
181, 261, 262, 266, 388

THE PERMIAN BASIN AREA RATE CASES

On Writs of Certiorari to the United States Court of Appeals for the Tenth Circuit

---

BRIEF FOR STANDARD OIL COMPANY OF TEXAS, A DIVISION OF CHEVRON OIL COMPANY, PETITIONER IN NO. 266 AND RESPONDENT IN NOS. 117, ET AL.

PRELIMINARY STATEMENT

This brief is filed by Standard Oil Company of Texas (hereinafter called "Standard"), a Division of Chevron Oil Company. Standard is a respondent in Nos. 100, 102, 117, 181, 261 and 262, and is the petitioner in No. 266. Pursuant to the Court's order (R. XII, 89), we file this brief both as petitioner and respondent.

OPINIONS BELOW

The opinion of the court of appeals (R. XII, 15-61) is reported at 375 F. 2d 6. The opinion of the court on rehearing (R. XII, 87-89) is reported at 375 F. 2d 35. The opinions and orders of the Federal Power Commission (R. 516d-826d, 827d-838d, 37s, 1105d-1132d, 1133d-1136d) are reported at 34 F.P.C. 159, 418, 424, 1068, 1082. The opinion of the hearing examiner (R. 97d-364d) is reported at 34 F.P.C. 306.

JURISDICTION

The judgment of the court of appeals was entered on January 20, 1967 (R. XII, 66). Standard's petition for rehearing was denied on April 18, 1967 (R. XII, 87-89). Its petition for a writ of certiorari was filed on June 19, 1967. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1) and section 19(b) of the Natural Gas Act, 15 U.S.C. 717r(b).

QUESTION PRESENTED

In common with other producers we submit that the court below correctly found reversible error in the Commission's failure to match revenues with cost of service, its treatment of quality deductions and its requirement that refunds be made on a rate schedule by rate schedule basis. These points are argued in other briefs. We confine this brief to one question.

The Commission fixed an area rate for new gas-well gas[1] by use of the familiar cost-of-service method.[2]

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[1] "Gas-well gas" is gas from gas condensate wells or dry gas wells. "New gas-well gas" is such gas sold under contracts dated January 1, 1961, or later.

[2] Commission Brief, p. 163, fn. 34.

The rate base upon which it allowed a return, however, was fixed at one-half of the required capital investment as found by the Commission. The question is whether the Commission validly restricted the return to such a partial rate base.

STATEMENT

Under the established rules for cost-of-service regulation a fair return must be allowed on the reasonable value of the property devoted to the public service.[3] In this case the Commission determined this reasonable value (i.e., the prudent capital investment in a unit of new gas-well gas), but then fixed the rate base at one-half this amount on the assumption that each separate unit of investment would deplete on a straight line basis over a twenty-year period and, therefore, the "average investment" during each of the twenty years would be one-half of the original capital outlay.

The method by which the Commission calculated the rate base is stated in its brief (pages 113-114):

> "... the Commission, simplifying a more complex actual production pattern, assumed that a gas well depletes at a uniform rate and is totally depleted at the end of 20 years. Since the producer thus has 20 years in which to recover his capital outlay, and since the Commission found that the annual capital-recovery cost (depletion, depreciation and amortization) was 3.95 cents per Mcf, the Commission concluded that the total investment required to produce one Mcf a year for twenty years was 79 cents, and that the average investment out-

[3] *Los Angeles Gas & Electric Corp.* v. *R.R. Com.*, 289 U.S. 287. (1933); *Bluefield Water Works & Improvement Co.* v. *Public Service Commission of West Virginia*, 262 U.S. 679 (1923).

standing at any given point of time was therefore 39.5 cents. Allowing for a time lag of one year between investment and first production, the Commission raised this figure to 43.45 cents. This is the unit rate base for new gas-well gas."

ARGUMENT

The Commission's use of the constant 50 percent rate base is in error for two reasons:

(1) It results in confiscation for the first ten years of the recovery period, presumably to be made up by excessive rates in the last ten years, and

(2) In a growing industry such as the gas producing industry, confiscatory rates of earlier years are in fact not made up after ten years; the rate continues to be inadequate until such indefinite time in the future as the industry begins to liquidate.

(1) Rates Presently Confiscatory Cannot Be Justified by the Promise of Future Excessive Returns

This Court long since established the principle that property cannot be taken for public use without the assurance of a reasonable return on the value of the property "at the time it is being used for the public."

> ". . . what the complainant is entitled to demand, in order that it may have 'just compensation' is 'a fair return upon the reasonable value of the property at the time it is being used for the public.'" *Los Angeles Gas & Electric Corp.* v. *R.R. Com.*, 289 U.S. 287, 305.

Regulated rates must allow a reasonable return on the value of the property "at the time of the taking", *West* v. *C&P Tel. Co.*, 295 U.S. 662, 671 (1935).

The Federal Power Commission heretofore has uniformly applied this rule. In *South Carolina Generating Co.*, 16 F.P.C. 52,[4] it was contended that rates should be constructed on a rate base computed by using the average investment in a facility over a twenty-five year period. The Commission rejected the contention, stating (16 F.P.C. 52, 57):

> "The solution offered by the Georgia Public Service Commission would be to allow a less than full compensatory rate during the first portion of the . . . life of the plant and a more than compensatory rate during the remaining life of the plant. Based upon the evidence in this record we cannot justify the level rate proposed by the Georgia Public Service Commission. It would result in an unreasonably low rate at one time and an unreasonably high rate at another. Losses incurred because a rate is too low at one time should not be made up in excessive rates in the future. *In the Matters of Atlantic Seaboard Corp.*, [11 F.P.C. 43]; cf. *Bluefield Co.* v. *Public Service Commission*, 262 U.S. 679."

The Commission cites no regulatory precedent or judicial sanction—and we know of none—supporting its holding in this case that a regulated industry must operate at less than a reasonable rate of return for a ten-year period in the expectation that in a subsequent ten-year period it may collect excess rates and thereby be made whole. Indeed, all authority is to the contrary. "Present confiscation is not atoned for by merely holding out the hope of a better life to come." (*West Ohio Gas Co.* v. *Public Utilities Comm. of Ohio*, 294 U.S. 79, 83 (1935)).

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[4] Remanded on other grounds, *South Carolina Generating Co.* v. *F.P.C.*, 249 F. 2d 755 (CA 4, 1957).

(2) Under the Commission's Formula the Gas Producing Industry Will Continue To Operate at an Inadequate Return Until It Begins To Liquidate

The vice of the Commission's formula goes far deeper than merely providing an inadequate return for ten years with a hoped for reimbursement from excess rates in the subsequent ten years. In reality—as applied to the actual facts of the industry—it provides an inadequate rate of return on the property devoted to the public use until some unforeseeable date when the industry's new gas-well gas properties as a whole (not any single asset) may become 50 percent depleted. It postpones the commencement of the recovery of the amount by which the return has been inadequate during this indefinite period until depletion of all such properties exceeds 50 percent, i.e., until new reserves added by the industry continue at a level less than current production.

The industry's new gas-well gas properties devoted to public use are made up of numerous producing properties in various stages of depletion. More are added each year. The average depletion of all of these assets is not now, and in the foreseeable future will not reach, 50 percent. The Commission found (R. 582d):

> "The record establishes that additions to proved reserves of natural gas in the United States have exceeded production in each year. We believe it essential to encourage a level of exploratory effort which will continue to provide for findings in excess of production."

The Commission and the courts have heretofore recognized that the average depreciation of all assets

of a growing company or industry (one whose new investments exceed its overall depreciation) will never be as great as 50 percent.

In *Alabama-Tennessee Natural Gas Company,* 31 F.P.C. 208, 215, aff'd. *Alabama-Tennessee Natural Gas Company* v. *F.P.C.,* 359 F. 2d 318 (CA 5, 1966), *cert. den.* 87 S. Ct. 69, (1966) *rehearing den.* 87 S. Ct. 390 (1966), the pipeline industry contended that use of accelerated depreciation rates permitted for income tax purposes would yield the same total depreciation charge, income and taxes over the life of each asset as would use of average depreciation rates calculated for book purposes. The gas pipeline industry argued that reduced taxes in the years prior to the mid-point of accelerated depreciation would be offset by excess taxes in the last half of the life of each asset, so that there would be no tax saving resulting from accelerated depreciation.

The Commission concluded that this was true as to each asset as taken separately, but was not true of all of the assets held by a growing industry. The Commission recognized that for a growing company or industry, the level of depreciation of all assets of all ages would never be as low as 50 percent, the average investment in a single asset over its lifetime. It held that reduced taxes on the newer properties would never be totally offset by the excess taxes on the older properties, so long as the industry continued to grow or even remained stable. The Court affirmed the Commission's decision. To the same effect are *Natural Gas Pipeline Company of America,* 33 F.P.C. 574; aff'd on this issue, *City of Chicago, et al.* v. *F.P.C.,* F. 2d (CADC, September 8, 1967).

The Commission's calculation of return[5] in this case is based on the very error which it rejected in the *Alabama-Tennessee* case, namely, the assumption that, like a single asset, the average depletion (or depreciation) of all assets owned by a growing industry will reach a level of 50 percent.

As noted above, the gas producing industry, like the gas pipeline industry, is a dynamic one. It regularly expands its capital investment to develop new gas reserves to meet ever-increasing demands of the gas markets. In the 15 years from the end of World War II until 1960 during which gas-well gas was produced in significant volumes in the Permian Basin (Comm. Br., pp. 5-6) such gas reached a state of depletion of only 25 percent for gas condensate leases and 37 percent for gas only or dry gas leases (Comm. Br., p. 131, fn. 3). In the much longer period during which gas well properties have been produced throughout the nation, the nationwide gas-well gas reserves have never become 50 percent depleted (Comm. Br., p. 131, fn. 3).

As experience has proved and the courts have recognized, so long as the gas producing industry continues to expand, there will never come a time when the aggregate new gas-well gas properties are as much as 50 percent depleted. It is not until the industry begins to liquidate that the investment in these properties will

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[5] "It must be evident that as far as cost incidence is concerned return and depreciation are alike as two peas in a pod. . . . One is a return on capital whereas the other is a return of capital. Clearly, consistency requires that both costs be treated alike." *Atlantic Seaboard Corporation, et al.*, 11 F.P.C. 43, 55.

decline to a level of less than 50 percent.[6] Until then the present rates fixed by the Commission will be confiscatory.

CONCLUSION

For the foregoing reasons we submit that the decision of the court below should be reversed.

Respectfully submitted,

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October 9, 1967

[6] The very purpose of fixing a separate area rate for new gas-well gas was "to stimulate exploration efforts" (Comm. Br., p. 112). Yet, as we have shown, the Commission's rate base promises the industry confiscation for the foreseeable future and, realistically, no hope of recovering the excess rates to compensate for the confiscation.

PETITIONER'S

REPLY

BRIEF

No. 100

FILED
NOV 28 196
JOHN F. DAVIS, CL

In the Supreme Court of the United States

OCTOBER TERM, 1967

PEOPLE OF THE STATE OF CALIFORNIA and PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA,

Petitioners,

vs.

SKELLY OIL COMPANY, PHILLIPS PETROLEUM COMPANY, WARREN PETROLEUM CORPORATION, MOBIL OIL CORPORATION (formerly Socony Mobil Oil Company, Inc.), PAN AMERICAN PETROLEUM CORPORATION, NORTHERN NATURAL GAS PRODUCING COMPANY,

[*Continued on Inside Cover*]

On Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

Reply Brief for Petitioners

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November 27, 1967

BORG PRINTING COMPANY OF CALIFORNIA, 346 FIRST STREET, SAN FRANCISCO 94105

[*Continued from Cover*]

STANDARD OIL COMPANY OF TEXAS, a Division of
Chevron Oil Company,
TEXACO INC.,
HUNT OIL COMPANY jointly with
H. L. Hunt,
Lamar Hunt,
N. B. Hunt,
W. H. Hunt,
Secure Trusts,
Caroline and Loyd B. Sands,
Caroline Hunt Trust Estate,
Lyda Hunt-Caroline Trusts,
Lyda Hunt-Bunker Trusts,
Lyda Hunt-Lamar Trusts,
Lyda Hunt-Herbert Trusts,
Lyda Hunt-Margaret Trusts
(formerly Estate of Lyda Bunker Hunt, Deceased),
Hunt Industries
(formerly Estate of Lyda Bunker Hunt, Deceased), and
Placid Oil Company,
HUMBLE OIL & REFINING COMPANY,
SHELL OIL COMPANY,
THE ATLANTIC RICHFIELD COMPANY (formerly
The Atlantic Refining Company) jointly with
Dorchester Gas Producing Company,
Southland Royalty Company, and
Westates Petroleum Company,
CONTINENTAL OIL COMPANY jointly with
Sunray DX Oil Company,
Sinclair Oil & Gas Company,
Cabot Corporation,
Sohio Petroleum Company,
Joseph E. Seagram & Sons, Inc.,
Joseph E. Seagram & Sons dba
Texas Pacific Oil Company,
Gulf Oil Corporation,
Murphy Oil Corporation,
The Nueces Company,
Samedan Oil Corporation,

[*Continued from Inside Cover*]

Cities Service Oil Company
(formerly Cities Service Petroleum Corporation),
Cities Service Production Company
(now merged with Cities Service Oil Company),
Columbian Fuel Corporation,
Amerada Petroleum Corporation,
Union Oil Company of California and as successor to
The Pure Oil Company,
Tidewater Oil Company,
Reef Corporation, and
William A. & Edward R. Hudson, Joint Operators,
MARATHON OIL COMPANY,
SUN OIL COMPANY,
INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA,
THE BRITISH-AMERICAN OIL PRODUCING COMPANY,
UNION TEXAS PETROLEUM, a Division of
Allied Chemical Corporation,
MIDHURST OIL CORPORATION,
THE SUPERIOR OIL COMPANY,
PERRY R. BASS jointly with
Panther City Investment Co.,
Bass Bros. Enterprise, Inc.,
Perry R. Bass, Incorporated, and
Richardson Oils, Inc.,
COLUMBIAN CARBON COMPANY jointly with
Coltexo Corporation,
THE STATE OF TEXAS,
BIG CHIEF DRILLING COMPANY jointly with
King-Stevenson Oil Co., Inc., and
Service Drilling Company,
TEXAS INDEPENDENT PRODUCERS & ROYALTY OWNERS
ASSOCIATION jointly with
West Central Texas Oil and Gas Association,
STATE OF NEW MEXICO,
GULF OIL CORPORATION, and
J. C. BARNES, *et al.*, *Respondents.*

(THE PERMIAN BASIN AREA RATE CASES)

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In the Supreme Court of the United States

OCTOBER TERM, 1967

No. 100

PEOPLE OF THE STATE OF CALIFORNIA AND PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA,
Petitioners,

vs.

SKELLY OIL COMPANY, *et al.*,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

Reply Brief for Petitioners

In accordance with Rule 41(3) of the Revised Rules of the Supreme Court of the United States, the petitioners, People of the State of California and Public Utilities Commission of the State of California (California), submit this reply brief.

I.

EFFECTIVE AREA REGULATION REQUIRES REFUNDS IN ACCORDANCE WITH THE COMMISSION'S DECISION

A. The Absence of a Recompensable Revenue Deficiency For Any Particular Producer Makes This Court's Decision in "Second Phillips" Inapplicable.

The producers defend the lower court's conclusion that refunds can be required only on a group basis. They argue

that *Second Phillips*[1] is controlling precedent on the refund question.[2]

The fundamental premise on which this argument is based is that the entire producing industry in the area — "the area entity"— must be substituted in this area rate case for the Phillips Petroleum Company, which was the entity considered by this Court in *Second Phillips.*

California submits that this argument ignores the vital fact that the Commission has determined uniform just and reasonable rates by use of the area method. Unlike *Second Phillips,* there is no finding that *a particular producer* has suffered a revenue deficiency for the test year or for any particular refund period. Moreover, there is no recompensable area revenue deficiency since area revenues balance area allowable costs to the extent necessary for area rate making under the Act. Once the Commission dismissed the Section 5(a) rate investigation in *Second Phillips,* in conformity with its decision to abandon individual company cost of service for producers, it was left only with a few incomplete Section 4(e) rate increase proceedings to be disposed of. Since allocation of costs to the various rates involved in the Section 4(e) proceedings would require "reopening the proceedings and the introduction of elaborate evidence," and since the Commission did not wish to disturb area rate patterns, it terminated the Section 4(e) proceedings without requiring refunds. *Phillips Petroleum Company,* 24 FPC 537, 576 (1960)

But in this first area rate proceeding, the Commission has expressly found just and reasonable area rates for

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1. *Wisconsin v. Federal Power Commission,* 373 U.S. 294 (1963)

2. Brief for Producer Respondents Supporting Decision of Court Below, pp. 69-86, hereinafter cited as "Prod. Brief."

past, present, and proposed sales of the producers in the area. (R. 687d) Refunds must be made of amounts collected subject to refund which exceed the just and reasonable rates. If *a particular producer* can show that such a procedure will result in confiscation as to him, he may file a petition for special relief and the Commission has stated that the payment of refunds will be stayed pending its determination. (R. 659d-660d)

Effective area regulation and protection of consumers requires that refunds be computed on a rate schedule by rate schedule basis. The producers' contracts or rate schedules are the subject matter of regulation under the Act. *United Gas Pipe Line Company v. Mobile Gas Service Corporation,* 350 U.S. 332 (1956); *Federal Power Commission v. Sierra Pacific Power Company,* 350 U.S. 348 (1956) The regulatory scheme of the Act "was one which built the regulatory system on a foundation of private contracts." *Sunray Mid-Continent Oil Company v. Federal Power Commission,* 364 U.S. 137, 154-5 (1960) Therefore, the producers must be required to weigh carefully a rate increase filing under Section 4(e). Under the area-wide refund decision of the lower court, all producers will be motivated to file Section 4(e) increases to the full extent possible under their contracts on the assumption that individual refund obligations may be much less or never arise at all. The exercise of sound business judgment by each producer as the basis for a decision to file a rate increase would be discouraged. Consumer protection under the Act would be undermined.

The Commission's approach to refunds adopts the traditional focus for regulation under the Act. It should be sustained.

B. The Question Regarding Refunds Below the "Last Clean Rate" Should Be Decided to Avoid Further Delay at the Expense of Consumers.

It is contended by the major producers that the question whether the Commission may order refunds below the last clean rate (i.e., the refund of the full amount of the increased rate, collected subject to refund under Section 4(e), which exceeds the applicable area rate) is not before this Court. (Prod. Brief, pp. 86-7) Other producers argue this question on the merits.[3]

The question was raised by certain producers on petitions for rehearing of Opinion No. 468. (R. 1117d) In Opinion No. 468-A the Commission deferred a decision on this issue since it was not presented with a specific situation involving refunds below the last clean rate. The major producers, however, on appeal to the court below, strenuously argued that the Commission's deferral was erroneous and that this issue was before the court since the invalidity of the Commission's position expressed in Opinion No. 468 was "obvious." (Opening Brief of Continental Oil Company, *et al.*, before the Court of Appeals, p. 98) Moreover, the producers supported their position by naming three specific rate schedules involving the last clean rate question.[4] Furthermore, the Court of Appeals held that the Commission must provide producers with an opportunity to petition for special relief "if a producer can show that a refund is required for collections at or below the

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3. See the brief of the Superior Oil Company (Superior), pp. 51-7, and the joint brief of Mobil Oil Corporation and Northern Natural Gas Producing Company (Mobil), pp. 66-72.

4. These rate schedules are: L. L. Horne, Rate Schedule No. 1; Scott Hammonds, Rate Schedule No. 1; and George S. Hammonds, Rate Schedule No. 1 (redesignated as Apco Oil Corporation, Rate Schedule No. 2). Opening Brief of Continental Oil Company, *et al.*, before the Court of Appeals, p. 98.

'last clean rate.'" (XII R. 58) It appears that the court was of the view that refunds could properly be ordered below the last clean rate, if special relief could be sought under such circumstances.[5] In any event, we urge affirmance of Opinion No. 468, and since this question is involved in at least three rate schedules, we urge this Court to decide it. It was a specific question of statutory interpretation raised by the producers for decision upon judicial review by the court below. Assuming affirmance of Opinion No. 468, only greater delay in receiving full refunds can result to consumers by deferring resolution of this question. California urges that this Court resolve it now.

Mobil and Superior assert that the Commission cannot refund any amount involved in a Section 4(e) proceeding below the last clean rate because such a refund would constitute retroactive rate making or unlawful restitution. (Mobil Brief, p. 67; Superior Brief, p. 53) This position ignores the fact that in Section 4(e) increased rate proceedings the former permanently certificated rate (the last clean rate) has been suspended pending determination by the Commission of the just and reasonable rate. The act of filing the Section 4(e) increase triggers initial review of the increased rate being requested. If suspension is ordered by the Commission the question is what is the appropriate just and reasonable rate. The entire increased rate, which now includes what used to be the last clean rate, is in question as being just and reasonable. The Commission must determine the lawful rate. Whatever deter-

5. It should be noted that the Commission did not specify with particularity the grounds for special relief. It should be further noted that under the group refund concept adopted by the Court of Appeals on rehearing, the last clean rate question may be more remote, for the purpose of the group refund concept appears to be the elimination of area revenue "deficiencies" owing to contract limitations, thereby reducing the possibility of any refunds.

mination the Commission makes, there is no retroactive rate making or unlawful restitution involved in such a situation.

Mobil and Superior improperly rely upon *Sunray Mid-Continent Oil Company v. Federal Power Commission*, 364 U.S. 137 (1960), a case involving the question whether, in a certificate application under Section 7 of the Act, the Commission could lawfully tender an indefinite certificate when the producer requested a certificate limited in time. The issue presented in the present area rate case as to the proper extent of the refund obligation under Section 4(e) was not before the Court in *Sunray Mid-Continent*.[6]

It is submitted that a more precise and appropriate opinion appears in the *Tennessee* case,[7] decided two years later. Significantly, *Tennessee* involved Section 4 and the order of a refund of amounts collected in excess of an interim rate order where a portion of a previously filed increased rate was found unjustified. Moreover, the Commission's rate reduction and refund order, while interim in nature, lowered certain rates in order to reflect a reduced rate of return and ordered full refunds under Section 4(e) "of the amounts collected in excess of the *lower, substituted charges* reflecting the lawful rate of return." (371 U.S. 145, 152; emphasis added) These lower, substituted charges,

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6. Mobil also quotes from *Federal Power Commission v. Hunt*, 376 U.S. 515 (1964), as authority for its position. (Mobil Brief, p. 70) This case concerned the conditioning of temporary certificates issued under Section 7. The quotation appearing in Mobil's brief is taken from this Court's explanation of the operation of Sections 5 and 7. In its analysis of Section 4 this Court expressed the view that a rate collected subject to refund under this section is refundable "to the extent the rate *is not just and reasonable.*" (376 U.S. 515, 522; emphasis added) Therefore, this decision does not support the producers as contended.

7. *Federal Power Commission v. Tennessee Gas Transmission Company*, 371 U.S. 145 (1962).

while only interim rates, were analogous to just and reasonable rates pending the completion of the proceeding. In the event that the completion of the proceeding did not have any effect on these substituted charges, they would become the lawful rates. In short, full refunds to the level of the expected new lawful rates were required, which is no different from what the Commission ordered in Opinion No. 468 with the lone exception that the applicable area rates are not interim rates.

The Commission's decision is given additional support on this question and is completely consistent with this Court's explanation in *Tennessee* of the policy of the Act with regard to Section 4(e):

> ". . . The company having initially filed the rates and either collected an illegal return or failed to collect a sufficient one must, under the theory of the Act, shoulder the hazards incident to its action including not only the refund of *any illegal gain* but also its losses where its filed rate is found to be inadequate." (371 U.S. 153; emphasis added)

The words "any illegal gain" can refer only to the full amount collected above the just and reasonable rate.

In other words, *Tennessee* clearly demonstrates that the lawful rate determined in a Section 4(e) proceeding, which is equivalent to the applicable area rate in this proceeding, is the base from which refunds must be calculated. This result is consistent with the policy stated in *Tennessee* that he who files for a rate increase under Section 4(e) shoulders the hazards involved in that procedure. (371 U.S. 145, 152-3) This result, which affects only those producers filing under Section 4(e), is reasonable in that it will further encourage sound business judgment as the basis for filing rate increases.

CONCLUSION

For the foregoing reasons, as well as for the reasons stated in its Brief for Petitioners, California urges that the judgment of the Court of Appeals be reversed with directions to affirm all the orders of the Commission involved herein.

Respectfully submitted,

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November 27, 1967

PETITION FOR REHEARING

October Term, 1967

Bass, Panther City Investment Co.
Bass Bros. Enterprises, Inc.
Perry R. Bass, Incorporated and
Richardson Oils, Inc.,

Petitioners

v.

Federal Power Commission,

Respondent

On Writ of Certiorari
to United States Court of Appeals
For the Tenth Circuit

PETITION FOR REHEARING

J. Evans Attwell
W. H. Dresser, Jr.

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CARD 54

No. 105

IN THE

Supreme Court of the United States

OCTOBER TERM, 1967

PERRY R. BASS, PANTHER CITY INVESTMENT CO.,
BASS BROS. ENTERPRISES, INC.,
PERRY R. BASS, INCORPORATED, AND
RICHARDSON OILS, INC.,
Petitioners,

v.

FEDERAL POWER COMMISSION,
Respondent.

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE TENTH CIRCUIT

PETITION FOR REHEARING

Petitioners, Perry R. Bass, et al,[1] pray that this Court grant rehearing of its opinion and order of May 1, 1968, affirming in part and reversing in part the judgments of the Court of Appeals for the Tenth Circuit and remanding the cases to that Court for further proceedings consistent with said opinion.[2]

[1] Referred to herein as "Bass".

[2] The Court's opinion was rendered in Nos. 90, et al entitled *"Permian Basin Area Rate Cases"*.

REASONS FOR GRANTING REHEARING

1. In an exhaustive opinion issued May 1, 1968, this Court affirmed in part and reversed in part the Permian Basin Area Rate Cases and remanded the cases to the United States Court of Appeals for the Tenth Circuit for further proceedings. The effect of the opinion was to affirm the Commission's decision in all respects. Although the Court's opinion touched on almost every issue raised by all Petitioners, it did not discuss the failure of the Federal Power Commission (Commission) to allow some price increment in the just and reasonable area rates fixed by the orders under review for the actual out-of-pocket costs incurred by producers, such as Bass, in gathering gas prior to its long distance transmission.[3] This issue was thoroughly briefed[4] and discussed on oral argument.[5] Bass does not suggest that the Court is required to write on all issues in complex cases such as this area rate proceeding. However, resolution of the gathering cost issue has importance to the proper determination and implementation of just and reasonable area rates for sales of natural gas in interstate commerce. This issue is particularly significant to producers in the Permian Basin because in that area substantial volumes of gas are gathered through facilities installed by producers prior to delivery of the gas to the purchasing pipelines. As detailed below, the Commission's failure to include an allowance for gathering costs in fixing just and reasonable area rates for the permian Basin results in

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[3] This was the major point raised by Bass in its petition for certiorari in No. 105. Bass also questioned whether the procedural due process was observed on the quality standards issue which the Court discussed at page 55 of its slip opinion.

[4] Bass' Brief, pp. 5-19; the Commission Brief, pp. 155-163 and Mobil Oil Corporation Brief, pp. 48-51.

[5] Oral argument presented by counsel for Bass and closing argument by counsel for the Commission.

unjustified discrimination against producers in that area who perform gathering services.[6]

2. As noted in Bass' brief, the Staff of the Commission is urging in *Area Rate Proceeding (Hugoton-Anadarko Area)* No. AR64-1 now in progress that an additional price increment for those producers performing the "gathering" function should be allowed. The suggested increment in that proceeding ranges from .9¢ per Mcf to 1.75¢ per Mcf. While the instant case was under submission to this Court, the Commission Staff recommended in *Area Rate Proceeding (Other Southwest Area)* No. AR67-1 that various increments (ranging from 1.0¢ to 1.25¢ per Mcf) be allowed producers for gathering gas in the many different gas producing provinces covered by that area proceeding. A Commission Staff exhibit showing such recommended increments for gathering is reproduced here as Appendix 1 to this Brief. It is apparent that the professional staff of the Commission has now accepted the fact that when producers perform the gathering function they should be compensated in the same manner as are regulated pipeline companies. If the Commission Staff's recommendations are accepted, the effect will be that Permian Basin producers, such as Bass, will be grossly discriminated against because they happen to have their principal gas production in the area chosen by the Commission for application of its first experimental area rate concept.

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[6] This discrimination is particularly acute as to those small producers who perform such gathering services in the Permian Basin area but do not have natural gas operations in any of the other producing areas.

3. The reversal urged by Bass to allow a price increment for producers who gather gas will not disturb the Court's original opinion in this case. The reversal will not entail long supplemental proceedings. Bass believes the record as it now exists contains sufficient information for the Commission to find the proper price increment for the "gathering" function. In the event that the Commission desires additional information, the present record can be simply updated with a minimum of effort and this already-too-long proceeding can be terminated quickly.

CONCLUSION

For the reasons set forth above and in the briefs heretofore filed in this cause, it is respectfully urged that rehearing be granted and that, upon such rehearing, the Court's opinion be supplemented to reverse the Commission for the reasons stated above.

Respectfully submitted,

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May 21, 1968

CERTIFICATE OF COUNSEL

I hereby certify that the foregoing petition for rehear-
g is presented in good faith and not for delay.

.....

J. Evans Attwell
Counsel for Petitioners

APPENDIX

Schedule No. 1
Sheet 1 of 1

Area Rate Proceeding
Other Southwest Area
Summary of Ceiling Rates & Quality Deductions

Line No.		Recommended Pricing Area (1)[1]			Recommended Pricing Area (2)[1]			Recommended Pricing Area (3)[1]
		Okla. Other (a)	Texas RRD #9 (b)	North Arkansas (c)	Texas RRD Nos. 5&6 (d)	North Louisiana (e)	South Arkansas (f)	Mississippi N. W. Ala. (g)
1.	I. New Gas Well Gas[2]							
2.	a. Seller Gathers	17.50	17.75	17.00	17.5	19.0	16.75	18.00
3.	b. Seller Does Not Gather	16.25	16.50	15.75	16.5	18.0	15.75	16.75
4.	II. All Other Gas[2]							
5.	a. Seller Gathers	17.00	17.25	16.50	14.0	15.75	13.5	15.50
6.	b. Seller Does Not Gather	15.75	16.00	15.25	13.0	14.75	12.5	15.25
7.	III. Deductions For All Gas Below							
8.	Recommended Quality Standard							
9.	Sour Gas	1.00	1.00	1.00	1.00	1.00	1.00	1.00
10.	Wet Gas	0.25	0.25	0.25	0.25	0.25	0.25	0.25
11.	Operating Pressure	1.50	1.50	1.50	1.25	1.25	1.25	0.85
12.	Acid (CO_2) Gas	1.00	1.00	1.00	1.00	1.00	1.00	1.00

Sources:
Lines 1-6: Sch. 3 & 4 and Testimony.
Lines 9-12: Sch. 3, Sh. 1, 2, 3, Section II, Col. (c) and Testimony.
[1] Pricing areas are described and delineated in Testimony. All Rates and Deductive Charges are stated in ¢/Mcf at a pressure base of 14.65 psia except for N. La., Miss., N. W. Ala. which are at 15.025 psia.
[2] Gathering is defined in Testimony.

1a

OPINION

SUPREME COURT OF THE UNITED STATES

Nos. 90, 95, 98, 99–102, 105, 117, 181, 261, 262, 266, 388.—October Term, 1967.

Permian Basin Area Rate Cases. | On Writs of Certiorari to the United States Court of Appeals for the Tenth Circuit.

[May 1, 1968.]

Mr. Justice Harlan delivered the opinion of the Court.

These cases stem from proceedings commenced in 1960 by the Federal Power Commission under § 5 (a) of the Natural Gas Act,[1] 52 Stat. 823, 15 U. S. C. § 717d (a), to determine maximum just and reasonable rates for sales in interstate commerce[2] of natural gas produced in the

[1] Section 5 (a) provides in pertinent part that "Whenever the Commission, after a hearing had upon its own motion or upon complaint of any State, municipality, State commission, or gas distributing company, shall find that any rate, charge, or classification demanded, observed, charged, or collected by any natural-gas company in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order . . . ."

[2] Section 1 (b), 15 U. S. C. § 717 (b), provides in part that the "provisions of this Chapter shall apply . . . to the sale in interstate commerce of natural gas for resale for ultimate public consumption for domestic, commercial, industrial, or any other use . . . ." We shall, for convenience, hereafter describe sales within the Commission's regulatory authority as "jurisdictional" or "interstate" sales.

Permian Basin.[3] 24 F. P. C. 1121. The Commission conducted extended hearings,[4] and in 1965 issued a decision that both prescribed such rates and provided various ancillary requirements. 34 F. P. C. 159, 34 F. P. C. 1068. On petitions for review, the Court of Appeals for the Tenth Circuit sustained in part and set aside in part the Commission's orders. 375 F. 2d 6, 375 F. 2d 35. Because these proceedings began a new era in the regulation of natural gas producers, we granted certiorari and consolidated the cases for briefing and extended oral argument. 387 U. S. 902, 388 U. S. 906, 389 U. S. 817. For reasons that follow, we reverse in part and affirm in part the judgments of the Court of Appeals, and sustain in their entirety the Commission's orders.

I.

The circumstances that led ultimately to these proceedings should first be recalled. The Commission's authority to regulate interstate sales of natural gas is derived entirely from the Natural Gas Act of 1938. 52 Stat. 821. The Act's provisions do not specifically extend to producers or to wellhead sales of natural gas,[5] and the Commission declined until 1954 to regulate sales by

[3] The Permian Basin was defined by the Commission's order commencing these proceedings so as to include Texas Railroad Commission Districts Nos. 7–C and 8, and the New Mexico counties of Lea, Eddy, and Chaves. *Area Rate Proceeding No. AR61–1*, 24 F. P. C. 1121, 1125.

[4] There were some 384 parties before the Commission, including 336 gas producers. Hearings began on October 11, 1961, and closed on September 10, 1963. The final transcript included more than 30,000 pages. The examiner's decision was issued on September 17, 1964. The Commission heard three days of oral argument, and issued its decision on August 5, 1965. A supplementary opinion denying applications for rehearing was issued on October 4, 1965.

[5] Indeed, § 1 (b), 15 U. S. C. § 717 (b), provides in part that the "provisions of this Chapter . . . shall not apply to . . . the production or gathering of natural gas."

independent producers[6] to interstate pipelines.[7] Its efforts to regulate such sales began only after this Court held in 1954 that independent producers are "natural gas compan[ies]" within the meaning of § 2 (6) of the Act. 15 U. S. C. § 717a (6); *Phillips Petroleum Co.* v. *Wisconsin*, 347 U. S. 672. The Commission has since labored with obvious difficulty to regulate a diverse and growing industry under the terms of an ill-suited statute.

The Commission initially sought to determine whether producers' rates were just and reasonable within the meaning of §§ 4 (a)[8] and 5 (a) by examination of each producer's costs of service.[9] Although this method has been widely employed in various rate-making situations,[10] it ultimately proved inappropriate for the regulation of independent producers. Producers of natural gas cannot usefully be classed as public utilities.[11] They en-

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[6] Independent producers are those that do "not engage in the interstate transmission of gas from the producing fields to consumer markets and [are] not affiliated with any interstate natural-gas pipeline company." *Phillips Petroleum Co.* v. *Wisconsin*, 347 U. S. 672, 675.

[7] This position was first adopted by the Commission in *Columbian Fuel Corp.*, 2 F. P. C. 200. See also *Billings Gas Co.*, 2 F. P. C. 288; *Tin-Ker Oil & Gas Production Co.*, 6 F. P. C. 92; *Tennessee Gas & Transmission Co.*, 6 F. P. C. 98.

[8] Section 4 (a), 15 U. S. C. § 717c (a), provides that "All rates and charges made, demanded, or received by any natural-gas company for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges, shall be just and reasonable, and any such rate or charge that is not just and reasonable is declared to be unlawful."

[9] See generally *Phillips Petroleum Co.*, 24 F. P. C. 537, 542.

[10] It has been observed that costs of service standards are "most generally accepted in the regulation of the levels of rates" charged by both publicly and privately owned utilities." J. Bonbright, Principles of Public Utility Rates 67 (1961).

[11] It has been said that "the primary, even though not the sole, distinguishing feature of a public utility enterprise is to be found

joy no franchises or guaranteed areas of service. They are intensely competitive vendors of a wasting commodity they have acquired only by costly and often unrewarded search. Their unit costs may rise and decline with the vagaries of good fortune. The value to the public of the services they perform is measured by the quantity and character of the natural gas they produce, and not by the resources they have expended in its search; the Commission and the consumer alike are concerned principally with "what [the producer] gets out of the ground, not . . . what he puts into it . . . ." *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U. S. 591, 649 (separate opinion). The exploration for and the production of natural gas are thus "more erratic and irregular and unpredictable in relation to investment than any phase of any other utility business." *Id.*, at 647. Moreover, the number both of independent producers and of jurisdictional sales is large,[12] and the administrative burdens placed upon the Commission by an individual company costs of service standard were therefore extremely heavy.[13]

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in a technology of production and transmission which almost inevitably leads to a complete or partial monopoly of the market for the service." Bonbright, *supra*, at 10. See also *Sunray Oil Co.* v. *F. P. C.*, 364 U. S. 137, 160 (dissenting opinion).

[12] The Commission in its second *Phillips* opinion stated that there were then 3,372 independent producers with rates on file; these producers had on file 11,091 rate schedules and 33,231 supplements to those schedules. There were, at the moment of the Commission's opinion, 570 producers involved in 3,278 rate increase filings awaiting hearings and decisions. 24 F. P. C., at 545. See for listings by sales of natural gas producers, Federal Power Commission, Sales by Producers of Natural Gas to Natural Gas Pipeline Companies 1963, 1 (1965).

[13] The Commission stated in its second *Phillips* that "if our present staff were immediately tripled, and if all new employees would be as competent as those we now have, we would not reach a current

In consequence, the Commission's regulation of producers' sales became increasingly laborious, until, in 1960, it was described as the "outstanding example in the federal government of the breakdown of the administrative process." [14] The Commission in 1960 acknowledged the gravity of its difficulties,[15] and announced that it would commence a series of proceedings under § 5 (a) in which it would determine maximum producers' rates for each of the major producing areas.[16] One member of the Commission has subsequently described these efforts as "admittedly . . . experimental . . . ." [17] These cases place in question the validity of the first such proceeding.[18]

The perimeter of this proceeding was drawn by the Commission in its second *Phillips* and in its Statement of General Policy No. 61–1. The Commission in *Phillips* asserted that it possesses statutory authority both to de-

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status in our independent producer rate work until 2043 A. D.—eighty-two and one half years from now." 24 F. P. C., at 546. It added that if "the plan of rate regulation we here announce is not lawful," it would follow that "as a practical matter, adequate regulation of producers appears to be impossible under existing law." *Id.*, at 547.

[14] Landis, Report on Regulatory Agencies to the President-Elect, printed for use of the Senate Committee on the Judiciary, 86th Cong., 2d Sess., 54. Contrast Landis, Theoretical and Practical Considerations with Reference to Price Regulation in Production and Transmission of Natural Gas, 13th Oil & Gas Inst. 401, 406 (1962).

[15] *Phillips Petroleum Co., supra,* at 542–548.

[16] *Id.*, at 547; Statement of General Policy No. 61–1, 24 F. P. C. 818.

[17] *Area Rate Proceeding (Hugoton-Anadarko Area) No. AR64–1,* 30 F. P. C. 1354, 1359 (dissenting opinion of Commissioner Ross).

[18] We are informed that four other area proceedings are pending in various stages before the Commission. These, in combination with the present proceeding, reach some 90% of the sales of natural gas subject to the Commission's jurisdiction. Brief for the Federal Power Commission 14–15.

termine and to require the application throughout a producing area of maximum rates for producers' interstate sales.[19] It averred that the adoption of area maximum rates would appreciably reduce its administrative difficulties, facilitate effective regulation, and ultimately prove better suited to the characteristics of the natural gas industry. Each of these conclusions was reaffirmed in the Commission's opinion in these proceedings.[20] Its Statement of General Policy tentatively designated various geographical areas as producing units for purposes of rate regulation; in addition, the Commission there provided two series of area guideline prices,[21] which were expected to help to determine "whether proposed initial rates should be certificated without a price condition and whether proposed rate changes should be accepted or suspended." [22] The Commission consolidated three of the producing areas listed in the Statement of General Policy for purposes of this proceeding.

The rate structure devised by the Commission for the Permian Basin includes two area maximum prices. The Commission provided one area maximum price for natural gas produced from gas wells and dedicated to inter-

[19] *Phillips Petroleum Co., supra,* at 548.

[20] It is proper to note that certain of the Commission's statements in *Phillips* concerning the difficulties of unit cost computations do not appear to have been entirely reaffirmed in its opinion in these proceedings. The two opinions are, however, broadly consistent, and the Commission is not, in any event, forbidden "to adapt their rules and practices to the Nation's needs in a volatile, changing economy." *American Trucking* v. *A., T. & S. F. R. Co.,* 387 U. S. 397, 416.

[21] The Statement provided separate guideline prices for initial filings and for increased rates. The Commission said merely that "prices in new contracts are, and in many cases by virtue of economic factors, must be higher than the prices contained in old contracts." 24 F. P. C., at 819. The guideline prices applicable to the producing areas subsequently included in these proceedings were in each case 16¢ and 11¢ per Mcf, with the higher price for initial filings.

[22] Statement of General Policy No. 61–1, *supra,* at 818.

state commerce after January 1, 1961.[23] It created a second, and lower, area maximum price for all other natural gas produced in the Permian Basin. The Commission reasoned that it may employ price functionally, as a tool to encourage discovery and production of appropriate supplies of natural gas. It found that price could serve as a meaningful incentive to exploration and production only for gas-well gas committed to interstate commerce since 1960; the supplies of associated and dissolved gas,[24] and of previously committed reserves of gas-well gas, were, in contrast, found to be relatively unresponsive to variations in price. The Commission expected that its adoption of separate maximum prices would both provide a suitable incentive to exploration and prevent excessive producer profits.

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[23] The Commission defined gas-well gas as "gas from dry gas reservoirs and gas condensate reservoirs, and gas from gas-cap wells." It added that gas-cap gas is "a special category of gas from an oil reservoir that can be produced free from the influence of oil production." 34 F. P. C. 159, 189 and n. 23. Residue gas derived from new gas-well gas is also to be subject to higher maximum rate. See *id.*, at 211.

[24] Natural gas is variously classified, and certain of the descriptive names that will be employed in this opinion should be briefly explained. Casinghead gas is "the common name for gas produced from oil wells in conjunction with the production of oil." 34 F. P. C., at 208. Residue gas is "the gas remaining after casinghead gas or gas-well gas has been processed to remove liquids present in the raw gas stream in the form of vapor or droplets." *Id.*, at 210. Associated gas is "[f]ree natural gas in immediate contact, but not in solution, with crude oil in the field or reservoir." American Gas Association, 1966 Gas Facts 246 ('66). Dissolved gas is that "in solution with crude oil in the reservoir." *Ibid.* Oil-well gas encompasses associated, dissolved, and casinghead gas, together with residue derived from casinghead gas. In addition, we shall adopt the Commission's usage, and on occasion describe gas subject to the lower maximum rate as "old" or "flowing" gas. 34 F. P. C., at 212, n. 31.

The Commission declined to calculate area rates from prevailing field prices. Instead, it derived the maximum just and reasonable rate for new gas-well gas from composite cost data, obtained from published sources and from producers through a series of cost questionnaires. This information was intended in combination to establish the national costs in 1960 of finding and producing gas-well gas; it was understood not to reflect any variations in cost peculiar either to the Permian Basin or to periods prior to 1960. The maximum just and reasonable rate for all other gas was derived chiefly from the historical costs of gas-well gas produced in the Permian Basin in 1960; the emphasis was here entirely local and historical. The Commission believed that the uncertainties of joint cost allocation made it difficult to compute accurately the cost of gas produced in association with oil.[25] It held, however, that the costs of such gas could not be greater, and must surely be smaller, than those incurred in the production of flowing gas-well gas. In addition, the Commission stated that the exigencies of administration demanded the smallest possible number of separate area rates.

Each of the area maximum rates adopted for the Permian Basin includes a return to the producer of 12% on average production investment, calculated from the

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[25] Joint costs "are incurred when products cannot be separately produced . . . ." M. Adelman, The Supply and Price of Natural Gas 25 (1962). Compare the following: "Products are 'truly joint' if they must be produced together and in constant proportions. Truly joint costs are variable costs. They vary (as a total) with the output of the entire set (fixed combination) of joint products." F. Machlup, The Economics of Sellers' Competition 21 (1952). And see Bonbright, *supra*, at 354–357. It appears to be conceded that even gas-well gas has costs jointly, as well as in common, with petroleum, but the Commission evidently, and permissibly, believed that the difficulties of allocation connected with gas-well gas were relatively uncomplicated. See 34 F. P. C., at 214–215, 339.

Commission's two series of cost computations. The Commission assumed for this purpose that production commences one year after investment, that gas wells deplete uniformly, and that they are totally depleted in 20 years. The rate of return was selected after study of the returns recently permitted to interstate pipelines, but, in addition, was intended to take fully into account the greater financial risks of exploration and production. The Commission recognized that producers are hostages to good fortune; they must expect that their programs of exploration will frequently prove unsuccessful, or that only gas of substandard quality will be found.

The allowances included in the return for the uncertainties of exploration were, however, paralleled by a system of quality and Btu adjustments.[26] The Commission held that gas of less than pipeline quality must be sold at reduced prices, and it provided for this purpose a system of quality standards. The price reduction appropriate in each sale is to be measured by the cost of the processing necessary to raise the gas to pipeline quality; these costs are to be determined by agreement between the parties to the sale, subject to review and approval by the Commission. The Commission ultimately indicated that it would accept any agreement which reflects "a good faith effort to approximate the processing costs involved . . . ." 34 F. P. C. 1068, 1071. In addition, the Commission prescribed that gas with a Btu content of less than 1,000 per cubic foot must be sold at a price proportionately lower than the applicable area maximum, and that gas with a Btu content greater than 1,050 per cubic foot may be sold at a price proportionately higher than the area maximum. The Commission acknowledged that the aggregate revenue consequences

[26] A Btu, or British thermal unit, is the amount of heat required to raise the temperature of one pound of water one degree Fahrenheit under stated conditions of pressure and temperature.

of these adjustments could not be precisely calculated, although its opinion denying applications for rehearing provided estimates of the average price reductions that would be necessary. *Id.*, at 1073.

The Commission derived from these calculations the following rates for the Permian Basin.[27] Gas-well gas, including its residue, and gas-cap gas, dedicated to interstate commerce after January 1, 1961, may be sold at 16.5¢ per Mcf (including state production taxes) in Texas, and 15.5¢ (excluding state production taxes) in New Mexico.[28] Flowing gas, including oil-well gas and gas-well gas dedicated to interstate commerce before January 1, 1961, may be sold at 14.5¢ per Mcf (including taxes) in Texas, and 13.5¢ per Mcf (excluding taxes) in New Mexico. Further, the Commission created a *minimum* just and reasonable rate of 9¢ per Mcf for all gas of pipeline quality sold under its jurisdiction within the Permian Basin. It found that existing contracts that included lower rates would "adversely affect the public interest." *FPC* v. *Sierra Pacific Power Co.*, 350 U. S. 348, 355. The Commission permitted producers to file under § 4 (d), 15 U. S. C. § 717c (d),[29] for the area min-

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[27] Tabular summaries of the cost components from which the distributors and the producers derived recommended rates for new gas-well gas may be found in the examiner's opinion. 34 F. P. C., at 343. Based on allowances for production investment costs, return, exploratory costs, royalty and production taxes, and other factors, the producers recommended a rate of 23.24¢ per Mcf; the distributors derived from the same factors a rate of 15.39¢ per Mcf. See also *id.*, at 357. Similar tables summarizing the Commission's findings were included in its opinion. *Id.*, at 192, 228.

[28] The Commission excluded New Mexico state production taxes because they are not uniform throughout the three counties. See the Commission's opinion denying applications for rehearing, 34 F. P. C., at 1074.

[29] Section 4 (d), 15 U. S. C. § 717c (d), provides in part that "[u]nless the Commission otherwise orders, no change shall be made

imum rate despite existing contractual limitations, and without the consent of the purchaser.

The Commission acknowledged that area maximum rates derived from composite cost data might in individual cases produce hardship, and declared that it would, in such cases, provide special relief. It emphasized that exceptions to the area rates would not be readily or frequently permitted, but declined to indicate in detail in what circumstances relief would be given.

This rate structure is supplemented by a series of ancillary requirements. First, the Commission provided various special exemptions for producers whose annual jurisdictional sales throughout the United States do not exceed 10,000,000 Mcf. The prices in sales by these relatively small producers need not be adjusted for quality and Btu deficiencies. Moreover, the Commission by separate order commenced a rule-making proceeding to reduce the small producers' reporting and filing obligations under §§ 4 and 7, 15 U. S. C. §§ 717c, f. 34 F. P. C. 434.

Second, the Commission imposed a moratorium until January 1, 1968, upon filings under § 4 (d) for prices in excess of the applicable area maximum rate. The Commission concluded that such a moratorium was imperative if the administrative benefits of an area proceeding were to be preserved. Further, it permanently prohibited the use of indefinite escalation clauses to increase prevailing contract prices above the applicable area maximum rate.[30]

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by any natural-gas company in any such rate, charge, classification, or service, or in any rule, regulation, or contract relating thereto, except after thirty days' notice to the Commission and to the public."

[30] The restricted contract provisions include most-favored-nation, spiral escalation and redetermination clauses. See *Pure Oil Co.*, 25 F. P. C. 383, 388, n. 3. They were said by the examiner to "cause price increases : . . to occur without reference to the circumstances or economics . . . ." 34 F. P. C., at 373 (initial decision of the presiding examiner).

Finally, the Commission announced that, by further order, it would require refunds of the difference between amounts that individual producers had actually collected in periods subject to refund, and the amounts that would have been permissible under the applicable area rate, including any necessary quality adjustments.[31] Small producers, although obliged to make refunds, are not required to take into account price reductions for quality deficiencies, unless they wish to take advantage of upward adjustments in price because of high Btu content. The Commission rejected the examiner's conclusion that refunds were appropriate only if the aggregate area revenue actually collected exceeds the aggregate area revenue permissible under the applicable area rates. It held that such a formula would prove both inequitable to purchasers and difficult for the Commission to administer effectively.

On petitions for review, the Court of Appeals for the Tenth Circuit held that the Commission had authority under the Natural Gas Act to impose maximum area rates upon producers' jurisdictional sales. It sustained, but stayed enforcement of, the Commission's moratorium upon filings under § 4 (d) in excess of the applicable area maximum rate. It approved both the Commission's two-price system and its exemptions for small producers. Nonetheless, the court concluded that the Commission failed to satisfy the requirements devised by this Court in *FPC* v. *Hope Natural Gas Co., supra.* It held that the Commission had not properly calculated the financial consequences of the quality and Btu adjustments, had not made essential findings as to aggregate revenue, and

[31] Many of the refund obligations in question here stem from the consolidation of proceedings conducted in connection with filings for rate increases under § 4 (d). For purposes of these filings and of the attendant refund obligations, these proceedings were conducted under § 4 (e). *Area Rate Proceeding No. AR61–1,* 24 F. P. C. 1121.

had not indicated with appropriate precision the circumstances in which relief from the area rates may be obtained by individual producers. 375 F. 2d 6. On rehearing, the court also held that the Commission's treatment of refunds was erroneous; it concluded that refunds were permissible only if aggregate actual area revenues have exceeded aggregate permissible area revenues, and only to the amount of the excess, apportioned on "some equitable contract-by-contract basis." The Court of Appeals ordered the cases remanded to the Commission for further proceedings consistent with its opinions. 375 F. 2d 35.

II.

The parties before this Court have together elected to place in question virtually every detail of the Commission's lengthy proceedings.[32] It must be said at the outset that, in assessing these disparate contentions, this Court's authority is essentially narrow and circumscribed.

[32] The various parties before the Court have taken quite disparate positions. The distributing companies, with the exception of *amici*, and the public authorities, with the exceptions of the States of Texas and New Mexico, have all supported the Commission's orders in their entirety. They urge that "consumers . . . have waited long enough," and assert that "no good purpose can be served by further proceedings." See Joint Brief for the City of San Diego and the City and County of San Francisco 24. Certain of the producers support the judgment below; others challenge the validity of portions of the Commission's orders that were sustained below. We have, nonetheless, frequently not indicated which of the parties join, and which oppose, various contentions. This does not suggest that we do not recognize differences in position; we want merely to simplify, so far as possible, an already lengthy opinion.

One further comment is pertinent. The organization and presentation of issues is, of course, a matter for the judgment of counsel. Nonetheless, it is proper to remark that the effectiveness and clarity with which issues are presented in cases of this complexity might be significantly increased if even greater efforts were made to focus and consolidate argumentation on behalf of parties with essentially similar views.

Section 19 (b) of the Natural Gas Act provides without qualification that the "finding of the Commission as to the facts, if supported by substantial evidence, shall be conclusive." More important, we have heretofore emphasized that Congress has entrusted the regulation of the natural gas industry to the informed judgment of the Commission, and not to the preferences of reviewing courts. A presumption of validity therefore attaches to each exercise of the Commission's expertise, and those who would overturn the Commission's judgment undertake "the heavy burden of making a convincing showing that it is invalid because it is unjust and unreasonable in its consequences." *FPC* v. *Hope Natural Gas Co., supra,* at 602. We are not obliged to examine each detail of the Commission's decision; if the "total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at an end." *Ibid.*

Moreover, this Court has often acknowledged that the Commission is not required by the Constitution or the Natural Gas Act to adopt as just and reasonable any particular rate level; rather, courts are without authority to set aside any rate selected by the Commission which is within a "zone of reasonableness." *FPC* v. *Natural Gas Pipeline Co.,* 315 U. S. 575, 585. No other rule would be consonant with the broad responsibilities given to the Commission by Congress; it must be free, within the limitations imposed by pertinent constitutional and statutory commands, to devise methods of regulation capable of equitably reconciling diverse and conflicting interests. It is on these premises that we proceed to assess the Commission's orders.

III.

The issues in controversy may conveniently be divided among four categories. In the first are questions of the Commission's statutory and constitutional authority to

employ area regulation and to impose various ancillary requirements. In the second are questions of the validity of the rate structure adopted by the Commission for natural gas produced in the Permian Basin. The third includes questions of the accuracy of the cost and other data from which the Commission derived the two area maximum prices. In the fourth are questions of the validity of the refund obligations imposed by the Commission.

We turn first to questions of the Commission's constitutional and statutory authority to adopt a system of area regulation and to impose various supplementary requirements. The most fundamental of these is whether the Commission may, consistently with the Constitution and the Natural Gas Act, regulate producers' interstate sales by the prescription of maximum area rates, rather than by proceedings conducted on an individual producer basis. This question was left unanswered in *Wisconsin* v. *Federal Power Commission*, 373 U. S. 294.[33] Its solution requires consideration of a series of interrelated problems.

It is plain that the Constitution does not forbid the imposition, in appropriate circumstances, of maximum prices upon commercial and other activities. A legislative power to create price ceilings has, in "countries where the common law prevails," been "customary from time immemorial . . . ." *Munn* v. *Illinois*, 94 U. S. 113, 133. Its exercise has regularly been approved by

[33] The opinion of the Court stated simply that "[w]e recognize the unusual difficulties inherent in regulating the price of a commodity such as natural gas. We respect the Commission's considered judgment, backed by sound and persuasive reasoning, that the individual company cost-of-service method is not a feasible or suitable one for regulating the rates of independent producers. We share the Commission's hopes that the area approach may prove to be the ultimate solution." 373 U. S., at 310 (note omitted).

this Court. See, *e. g.*, *Tagg Bros.* v. *United States*, 280 U. S. 420; *Bowles* v. *Willingham*, 321 U. S. 503. No more does the Constitution prohibit the determination of rates through group or class proceedings. This Court has repeatedly recognized that legislatures and administrative agencies may calculate rates for a regulated class without first evaluating the separate financial position of each member of the class; it has been thought to be sufficient if the agency has before it representative evidence, ample in quantity to measure with appropriate precision the financial and other requirements of the pertinent parties. See *Tagg Bros.* v. *United States*, *supra*; *Acker* v. *United States*, 298 U. S. 426; *United States* v. *Corrick*, 298 U. S. 435. Compare *New England Divisions Case*, 261 U. S. 184, 196–199; *United States* v. *Abilene & S. R. Co.*, 265 U. S. 274, 290–291; *New York* v. *United States*, 331 U. S. 284; *Chicago & N. W. R. Co.* v. *A., T. & S. F. R. Co.*, 387 U. S. 326, 341.

No constitutional objection arises from the imposition of maximum prices merely because "high cost operators may be more seriously affected . . . than others," *Bowles* v. *Willingham*, *supra*, at 518, or because the value of regulated property is reduced as a consequence of regulation. *FPC* v. *Hope Natural Gas Co.*, *supra*, at 601. Regulation may, consistently with the Constitution, limit stringently the return recovered on investment, for investors' interests provide only one of the variables in the constitutional calculus of reasonableness. *Covington & Lexington Turnpike Co.* v. *Sandford*, 164 U. S. 578, 596.

It is, however, plain that the "power to regulate is not a power to destroy," *Stone* v. *Farmers' Loan & Trust Co.*, 116 U. S. 307, 331; *Covington & Lexington Turnpike Co.* v. *Sandford*, *supra*, at 593; and that maximum rates must be calculated for a regulated class in conformity with the pertinent constitutional limitations. Price control is "unconstitutional . . . if arbitrary, discrim-

inatory, or demonstrably irrelevant to the policy the legislature is free to adopt . . . ." *Nebbia* v. *New York*, 291 U. S. 502, 539. Nonetheless, the just and reasonable standard of the Natural Gas Act "coincides" with the applicable constitutional standards, *FPC* v. *Natural Gas Pipeline Co., supra,* at 586, and any rate selected by the Commission from the broad zone of reasonableness permitted by the Act cannot properly be attacked as confiscatory. Accordingly, there can be no constitutional objection if the Commission, in its calculation of rates, takes fully into account the various interests which Congress has required it to reconcile. We do not suggest that maximum rates computed for a group or geographical area can never be confiscatory; we hold only that any such rates, determined in conformity with the Natural Gas Act, and intended to "balanc[e] . . . the investor and the consumer interests," are constitutionally permissible. *FPC* v. *Hope Natural Gas Co., supra,* at 603.

One additional constitutional consideration remains. The producers have urged, and certain of this Court's decisions might be understood to have suggested, that if maximum rates are jointly determined for a group or area, the members of the regulated class must, under the Constitution, be proffered opportunities either to withdraw from the regulated activity or to seek special relief from the group rates.[34] We need not determine whether this is in every situation constitutionally imperative, for such arrangements have here been provided by the Commission, and we cannot now hold them inadequate.

The Commission declared that a producer should be permitted "appropriate relief" if it establishes that its "out-of-pocket expenses in connection with the operation of a particular well" exceed its revenue from the

[34] Compare *Bowles* v. *Willingham, supra,* at 517.

well under the applicable area price. 34 F. P. C., at 226. It did not indicate which operating expenses would be pertinent for these calculations.[35] The Commission acknowledged that there might be other circumstances in which relief should be given, but declined to enumerate them. It emphasized, however, that a producer's inability to recover either its unsuccessful exploration costs or the full 12% return on its production investment would not, without more, warrant relief. It announced that in many situations it would authorize abandonment under § 7 (b), 15 U. S. C. § 717f (b),[36] rather than an exception to the area maximum price. Finally, the Commission held that the burden would be upon the producer to establish the propriety of an exception, and that it therefore would not stay enforcement of the area rates pending disposition of individual petitions for special relief.

The Court of Appeals held that these arrangements were inadequate. It found the Commission's description of its intentions vague. The court would require the Commission to provide "guidelines which if followed by an aggrieved producer will permit it to be heard promptly and to have a stay of the general rate order until its claim for exemption is decided." 375 F. 2d, at 30. We cannot agree. It would doubtless be desirable if the Commission

[35] The Court of Appeals remarked that "[o]ut-of-pocket expenses are not defined and we do not know what they include." 375 F. 2d, at 30. It is certainly true that the Commission proffered no definition, but we cannot regard this as a fatal omission.

[36] Section 7(b), 15 U. S. C. § 717f (b), provides that "[n]o natural-gas company shall abandon all or any portion of its facilities subject to the jurisdiction of the Commission, or any service rendered by means of such facilities, without the permission and approval of the Commission first had and obtained, after due hearing, and a finding by the Commission that the available supply of natural gas is depleted to the extent that the continuance of service is unwarranted, or that the present or future public convenience or necessity permit such abandonment."

provided, as quickly as may be prudent, a more precise summary of its conditions for special relief, but it was not obliged to delay area regulation until such guidelines could be properly drawn. The Commission quite reasonably believed that the terms of any exceptional relief should be developed as its experience with area regulation lengthens. Moreover, area regulation of producer prices is avowedly still experimental in its terms and uncertain in its ultimate consequences; it is entirely possible that the Commission may later find that its area rate structure for the Permian Basin requires significant modification.[37] We cannot now hold that, in these circumstances, the Commission's broad guarantees of special relief were inadequate or excessively imprecise.

Nor is there reason now to suppose that petitions for relief will not be expeditiously evaluated; for the Commission has given assurance that they will be "disposed of as promptly as possible."[38] If it subsequently appears that the Commission's provisions for special relief are for any reason impermissibly dilatory, this question may then be reconsidered.

Furthermore, it is pertinent that the Commission may supplement its provisions for special relief by permitting abandonment of unprofitable activities. The producers

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[37] Indeed, Commissioner Ross has already urged that the Commission modify its area proceedings so as to reflect the essentially national character of the relevant issues. *Area Rate Proceeding (Hugoton-Anadarko Area) No. AR64–1*, 30 F. P. C. 1354, 1359–1362 (dissenting opinion). Moreover, we note the "essential amalgamation" of the Hugoton-Anadarko and Texas Gulf Coast area proceedings before the Commission, where "identical issues were heard on a joint record." 1 Joint Initial Staff Brief in Area Rate Proceedings Nos. AR64–1 and AR64–2, 1. Finally, we must emphasize that we understand the present proceeding to be merely the first of many steps toward a more expeditious and effective system of regulation.

[38] 34 F. P. C., at 227.

urge that this source of relief must be disregarded, since it is entirely conditional upon the Commission's assent. It is enough for present purposes that the Commission has in other circumstances allowed abandonment,[39] and that it has indicated that it will, in appropriate cases, authorize it here. Indeed, the Commission has already acknowledged that only in "exceptional situations" would the abandonment of unprofitable facilities prove detrimental to consumers, and thus impermissible under § 7 (b). 34 F. P. C., at 226.

Finally, we cannot agree that the Commission abused its discretion by its refusal to stay, *pro tanto*, enforcement of the area rates pending disposition of producers' petitions for special relief. The Court of Appeals would evidently require the Commission automatically to issue such a stay each time a producer seeks relief. This is plainly inconsistent with the established rule that a party is not ordinarily granted a stay of an administrative order without an appropriate showing of irreparable injury. See, *e. g., Virginia Petroleum Jobbers Assn.* v. *FPC*, 259 F. 2d 921, 925. Moreover, the issuance of a stay of an administrative order pending disposition by the Commission of a motion to "modify or set aside, in whole or in part" the order is a matter committed by the Natural Gas Act to the Commission's discretion. §§ 19 (a), (c); 15 U. S. C. §§ 717r (a), (c). We have no reason now to believe that it would in all cases prove an abuse of discretion for the Commission to deny a stay of the area rate order. There might be many situations in which a stay would be inappropriate; at a minimum, the Commission is entitled to give careful consideration to the substantiality of the claim for relief, and to the consequences of any delay in the full administration of the area rate structure. We therefore decline to bind the Commission to any inflexible obligation; we shall assume

[39] See, *e. g., Transcontinental Gas Pipeline Corp.*, 34 F. P. C. 584.

that it will, in situations in which stays prove appropriate, properly exercise its statutory authority.

For the reasons indicated, we find no constitutional infirmity in the Commission's adoption of an area maximum rate system for the Permian Basin.

We consider next the claims that the Commission has exceeded the authority given it by the Natural Gas Act. The first and most important of these questions is whether, despite the absence of any constitutional deficiency, area regulation is inconsistent with the terms of the Act. The producers that seek reversal of the judgments below offer three principal contentions on this question. First, they emphasize that the Act uniformly employs the singular to describe those subject to its requirements; § 4 (a), for example, provides that rates received by "any natural gas company" must be just and reasonable. It is urged that the draftsman's choice of number indicates that each producer's rates must be individually computed from evidence of its own financial position. We cannot infer so much from so little; we see no more in the draftsman's choice of phrase than that the Act's obligations are imposed severally upon each producer.

Reliance is next placed upon one sentence in the Report of the House Committee on Interstate and Foreign Commerce, which in 1937 recommended passage of the Natural Gas Act. The Committee remarked that the "bill provides for regulation along recognized and more or less standardized lines." H. R. Rep. No. 709, 75th Cong., 1st Sess., 3. It added that the bill's provisions included nothing "novel." *Ibid.* We find these statements entirely inconclusive, particularly since, as the Committee doubtless was aware, regulation by group or class was a recognized administrative method even in 1937. Compare *Tagg Bros.* v. *United States, supra; New England Divisions Case, supra.* See also H. R. Rep. No.

77, 67th Cong., 1st Sess., 10–11; H. R. Rep. No. 456, 66th Cong., 1st Sess., 29–30.

Finally, the producers urge that two opinions of this Court establish the inconsistency of area regulation with the Natural Gas Act. It is asserted that the failure of a majority of the Court to adopt the reasoning of Mr. Justice Jackson's separate opinion in *FPC* v. *Hope Natural Gas Co., supra,* impliedly rejected the system of regulation now selected by the Commission. We find this without force. The Court in *Hope* emphasized that we may not impose methods of regulation upon the discretion of the Commission; for purposes of judicial review, the validity of a rate order is determined by "the result reached not the method employed." 320 U. S., at 602; see also *FPC* v. *Natural Gas Pipeline Co., supra,* at 586. The Court there did not reject area regulation; it repudiated instead the suggestion that courts may properly require the Commission to employ any particular regulatory formula or combination of formulae.

The producers next rely upon a dictum in the opinion of the Court in *Bowles* v. *Willingham, supra.* The Court remarked that "under other price-fixing statutes such as the Natural Gas Act of 1938 . . . Congress has provided for the fixing of rates which are just and reasonable in their application to particular persons or companies." 321 U. S., at 517. The dictum is imprecise, but even if it were not, we could not agree that it can now be controlling. The construction of Natural Gas Act was not even obliquely at issue in *Bowles,* and this Court does not decide important questions of law by cursory dicta inserted in unrelated cases. Whatever the dictum's meaning, we do not regard it as decisive here. And compare *Wisconsin* v. *Federal Power Commission,* 373 U. S. 294, 310.

There are, moreover, other factors that indicate persuasively that the Natural Gas Act should be understood to permit area regulation. The Act was intended to create, through the exercise of the national power over interstate commerce, "an agency for regulating the wholesale distribution to public service companies of natural gas moving interstate"; *Illinois Gas Co.* v. *Public Service Co.*, 314 U. S. 498, 506; it was for this purpose expected to "balanc[e] . . . the investor and the consumer interests." *FPC* v. *Hope Natural Gas Co., supra,* at 603. This Court has repeatedly held that the width of administrative authority must be measured in part by the purposes for which it was conferred; see, *e. g., Piedmont & Northern R. Co.* v. *Comm'n,* 286 U. S. 299; *Phelps Dodge Corp.* v. *Labor Board,* 313 U. S. 177, 193–194; *National Broadcasting Co.* v. *United States,* 319 U. S. 190; *American Trucking Assns.* v. *United States,* 344 U. S. 298, 311. Surely the Commission's broad responsibilities therefore demand a generous construction of its statutory authority.[40]

Such a construction is consistent with the view of administrative rate-making uniformly taken by this Court. The Court has said that the "legislative discretion implied in the rate-making power necessarily extends to the entire legislative process, embracing the method used in reaching the legislative determination as well as that determination itself." *Los Angeles Gas Co.* v. *Railroad Commission,* 289 U. S. 287, 304. And see *San Diego Land & Town Co.* v. *Jasper,* 189 U. S. 439, 446. It follows that rate-making agencies are not bound to the service of any single regulatory formula;

[40] We obtain additional assistance from § 16; it provides that the Commission "shall have power to perform any and all acts, and to prescribe . . . such orders, rules, and regulations as it may find necessary or appropriate to carry out the provisions of this" Act. 15 U. S. C. § 717*o*.

they are permitted, unless their statutory authority otherwise plainly indicates, "to make the pragmatic adjustments which may be called for by particular circumstances." *FPC* v. *Natural Gas Pipeline Co.*, *supra*, at 586.

We are unwilling, in the circumstances now presented, to depart from these principles. The Commission has asserted, and the history of producer regulation has confirmed, that the ultimate achievement of the Commission's regulatory purposes may easily depend upon the contrivance of more expeditious administrative methods. The Commission believes that the elements of such methods may be found in area proceedings. "[C]onsiderations of feasibility and practicality are certainly germane" to the issues before us. *Bowles* v. *Willingham*, *supra*, at 517. We cannot, in these circumstances, conclude that Congress has given authority inadequate to achieve with reasonable effectiveness the purposes for which it has acted.

We must now consider whether the Commission exceeded its statutory authority by the promulgation of various supplementary requirements. The first of these is its imposition of a moratorium until January 1, 1968, upon filings under § 4 (d) for prices in excess of the applicable area maximum rate. Although the period for which the moratorium was to be effective has expired, the order is not without continuing effect. The Court of Appeals stayed enforcement of the moratorium until final disposition of the petitions for review, and a number of rate increases have therefore become effective subject to invalidation and refund if the moratorium order is now upheld. See Brief for the Federal Power Commission 69, n. 44.

The validity of the moratorium order turns principally upon construction of §§ 4 and 5 of the Act. Section

4 (d)[41] provides that no modification in existing rate schedules may be made by a natural gas company except after 30 days notice to the Commission. When the Commission receives such notice, it is permitted by § 4 (e),[42] upon complaint or on its own motion, to suspend the proposed rate schedule for a period not to exceed five months. The Commission is to employ the period of suspension to conduct hearings upon the lawfulness of the proposed rates. If at the end of the suspension period appropriate orders have not been issued, the proposed rate schedule becomes effective, subject only to a refund obligation. In contrast, § 5 (a)[43] permits the Commission, upon complaint from a public agency or a gas distributing company, or on its own motion, to conduct proceedings to determine whether existing rates are just and reasonable, and to prescribe rates "to be thereafter observed and in

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[41] Section 4 (d) is set out at n. 29, *ante*.

[42] Section 4 (e), 15 U. S. C. § 717c (e), provides in part that "[w]henever any such new schedule is filed the Commission shall have authority, either upon complaint . . . or upon its own initiative . . . to enter upon a hearing concerning the lawfulness of such rate, charge, classification, or service; and, pending such hearing and the decision thereon, the Commission . . . may suspend the operation of such schedule *and refer the use of such rate* . . . but not for a longer period than five months beyond the time when it would otherwise go into effect, and after full hearings, either completed before or after the rate, charge, classification, or service goes into effect, the Commission may make such orders with reference thereto as would be proper in a proceeding initiated after it became effective. If the proceeding has not been concluded and an order made at the expiration of the suspension period . . . the proposed rate . . . shall go into effect. Where increased rates or charges are thus made effective, the Commission may, by order, require the natural-gas company to furnish a bond . . . and, upon completion of the hearing and decision, to order such natural-gas company to refund, with interest, the portion of such increased rates or charges by its decision found not justified."

[43] See n. 1, *ante*.

force . . . ." These investigatory powers are not conditional upon the filing by a natural gas company of any proposed change in existing rates.

Certain of the producers urge that §§ 4 and 5 must in combination be understood to preclude moratoria upon filings under § 4 (d). They assert that the period of effectiveness of a rate determination under § 5 (a) is limited by § 4 (e); they reason that § 4 (d) creates an unrestricted right to file rate changes, and that such changes may, under § 4 (e), be suspended for a period no longer than five months. If this construction were accepted, it would follow that area proceedings would terminate in rate limitations that could be disregarded by producers five months after their promulgation. The result, as the Commission observed, would be that "the conclusion of one area proceeding would only signal the beginning of the next, and just and reasonable rates for consumers would always be one area proceeding away." 34 F. P. C., at 228.

We cannot construe the Commission's statutory authority so restrictively. Nothing in § 5 (a) imposes limitations of time upon the effectiveness of rate determinations issued under it; rather, the section provides that rates held to be just and reasonable are "to be thereafter observed . . . ." Moreover, this Court has already declined to find in §§ 4 (d) or 4 (e) an "invincible right to raise prices subject to a six-month delay and refund liability." *United Gas* v. *Callery Properties*, 382 U. S. 223, 232 (opinion concurring in part and dissenting in part). Section 4 (d) merely requires notice to the Commission as a condition of any modification of existing rates; it provides that a "change *cannot* be made without the proper notice to the Commission; it does not say under what circumstances a change *can* be made." *United Gas Co.* v. *Mobile Gas Corp.*, 350 U. S. 332, 339. (Emphasis in original.) Nor does § 4 (e) restrict the

Commission's authority under § 5 (a); it permits the Commission to preserve an existing situation pending consideration of a proposed change in rates, and thereafter to issue an order retroactively forbidding the change; but the "scope and purpose of the Commission's review [under § 5 (a)] remain the same . . . ." *Id.*, at 341.

The deficiencies of the producers' construction of §§ 4 and 5 are illustrated by *United Gas* v. *Callery Properties, supra.* The Court held in *Callery* that permanent certifications issued under § 7 may be conditioned, even upon remand, by a moratorium upon filings under § 4 (d) for rates in excess of a specified ceiling. At issue were conditions imposed under § 7 (e) prior to the determination of just and reasonable rates; but nothing in the pertinent statutory provisions suggests that the Commission's authority under § 5 (a) is more narrow. Indeed, if the producers' construction of §§ 4 and 5 were adopted, we should be forced to the uncomfortable result that filings under § 4 (d) may be precluded by the Commission's relatively summary determination of a provisional in-line price, but not by its formal adjudication, after full deliberation, of a just and reasonable price. The consequences of such a construction would, as the Commission observed, be the enervation of § 5 and the effective destruction of area regulation. We are, in the absence of compelling evidence that such was Congress' intention, unwilling to prohibit administrative action imperative for the achievement of an agency's ultimate purposes. We have found no such evidence here, and therefore hold that the Commission may under §§ 5 and 16 restrict filings under § 4 (d) of proposed rates higher than those determined by the Commission to be just and reasonable.

The question remains whether the imposition by the Commission of a moratorium until January 1, 1968, was

a permissible exercise of this authority. The Commission found that in 1960 the costs of gas production had recently been, and would foreseeably remain, "remarkably steady"; [44] it reasoned that in these circumstances a moratorium of 2½ years, subject to "modification of its original decision after appropriate proceedings held in that docket," [45] would both facilitate orderly administration and satisfactorily assure the protection of producers' rights. Individual producers would not have been prevented by the moratorium from seeking relief from the maximum area rates; relief would have been possible both through the Commission's provisions for special exemptions and through motions for modification or termination of the moratorium. This is not a case in which the Commission has sought to bind producers, without recourse and in the face of changing circumstances, to an unchanging rate structure.

We cannot, given the apparent stability of production costs, the Commission's relative inexperience with area regulation, and the administrative burdens of concurrent area proceedings, hold that this arrangement was impermissible. We need not attempt to prescribe the limitations of the Commission's authority under §§ 5 and 16 to impose moratoria upon § 4 (d) filings; in particular, we intimate no views on the propriety of moratoria created in circumstances of changing costs. These and other difficult issues may more properly await both clarification of the Commission's intentions and the necessities of the particular circumstances. We hold only that this relatively brief moratorium did not, in the circumstances here presented, exceed or abuse the Commission's authority.

A collateral issue of statutory authority must be considered. The Commission supplemented its mora-

[44] 34 F. P. C., at 228.
[45] *Id.*, at 230.

torium by prohibiting price increases that exceed the area maximum rates, if the increases are the products of certain varieties of contractual price escalation clauses. Unlike the more general moratorium upon filings under § 4 (d), this proscription is without limit of time. The Commission's order is applicable to the most-favored-nation, spiral escalation and redetermination clauses [46] that in 1961 it entirely forbade in contracts executed on or after April 3, 1961; [47] the additional limitation provided here by the Commission was intended to restrict the use of clauses included in contracts executed before the date of effectiveness of the Commission's earlier orders. The Commission reasoned, as had the examiner, that to permit producers to breach the area maximum rates by implementation of such clauses would not be "in accordance with the principles upon which a rate structure should be based." 34 F. P. C., at 236.

Indefinite escalation clauses "cause price increases . . . to occur without reference to the circumstances or economics of the particular operation, but solely because

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[46] The Commission has elsewhere provided brief definitions of the pertinent types of clauses. See generally *Pure Oil Co.*, 25 F. P. C. 383. Two-party most-favored-nation clauses are those "activated by higher prices paid to any other supplier by the same purchaser." Three-party most-favored-nation clauses are "activated by higher prices paid to any other supplier by any purchaser." Spiral escalation clauses provide "that in the event the price which the buyer receives for the gas is increased, the price concurrently paid by the buyer to the supplier under the contract shall be increased in proportion to the buyer's increase." Redetermination clauses provide "that the price currently paid under the contract shall be subject to upward adjustment at certain specified times to reflect the average of the highest prices then paid by buyers to other suppliers for gas delivered under substantially similar terms and conditions." *Id.*, at 388, n. 3.

[47] Order No. 232, 25 F. P. C. 379. This was subsequently modified by Order No. 242, 27 F. P. C. 339. See 18 CFR § 154.93.

of what happens under another contract." 34 F. P. C., at 373. There is substantial evidence[48] that in design and function they are "incompatible with the public interest . . . ." Order No. 232, 25 F. P. C. 379, 380. Indeed, this Court has already entirely sustained the Commission's 1962 order. *Federal Power Commission* v. *Texaco*, 377 U. S. 33.

The producers do not suggest that the Commission and Court were there mistaken; they urge instead that the Commission has acted inconsistently with its decision in *Pure Oil Co.*, 25 F. P. C. 383, and that it has wrongly invalidated existing contracts. The Commission declined in *Pure Oil* to declare unenforceable escalation clauses included in previously executed contracts. It reasoned that since the contracts lacked severability provisions, to strike the escalation clauses would, under "familiar principles of law," destroy the contracts; it feared that this would prove "many times" more prejudicial to the public interest than would the escalation clauses. *Id.*, at 388–389. The producers assert that the Commission has now committed the error that it avoided in *Pure Oil*. The Commission rejoins that it has not stricken the escalation clauses; it has merely limited their application to prices no higher than the area maximum rates. Alternatively, the Commission avers that even if the contracts have been frustrated, neither the public nor the producers can suffer, since producers' prices may be as high, but not higher, than the area maximum.

We think that the Commission did not exceed or abuse its authority. Section 5 (a) provides without qualifica-

[48] The Commission stated in its Order No. 242 that indefinite escalation clauses "have created a significant portion of the administrative burdens under which this Commission is laboring," and that they produce a "flood of almost simultaneous filings" that "bear no apparent relationship to the economic requirements of the producers who file them." 27 F. P. C. 339, 340. See also 5 Joint Appendix 1858–1859.

tion or exception that the Commission may determine whether "any rate, regulation, practice, or other contract affecting . . . [any] rate . . . is unjust, unreasonable, unduly discriminatory, or preferential . . . ," and prescribe the "rule, regulation, practice, or contract to be thereafter observed. . . ." Although the Natural Gas Act is premised upon a continuing system of private contracting, *United Gas Co.* v. *Mobile Gas Corp., supra,* the Commission has plenary authority to limit or to proscribe contractual arrangements that contravene the relevant public interests. Compare *Federal Power Commission* v. *Sierra Pacific Power Co.,* 350 U. S. 348. Nor may its order properly be set aside merely because the Commission has on an earlier occasion reached another result; administrative authorities must be permitted, consistently with the obligations of due process, to adapt their rules and policies to the demands of changing circumstances. Compare *American Trucking* v. *Atchison, T. & S. F. R. Co., supra,* at 416. See 2 K. Davis, Administrative Law Treatise § 18.09, at 610 (1958). We need not, for present purposes, calculate what collateral consequences, if any, the Commission's order may have for the terms or validity of the contracts it reaches; we hold only that the Commission has here permissibly restricted the application of indefinite escalation clauses.

The next supplementary order to be considered is the Commission's creation of various exemptions for the smaller producers. The difficulties of the smaller producers differ only in emphasis from those of the larger independent producers and the integrated producer-distributors; but these differences are not without relevant importance.[49] Although the resources of the small pro-

[49] The Commission defined a small producer as one "selling jurisdictionally less than 10,000,000 Mcf annually on a nationwide basis." 34 F. P. C., at 235. See further the testimony of producer witness Abel, 1 Joint Appendix 339–342. This would include some

ducers are ordinarily more limited, their activities are characteristically financially more hazardous.[50] It appears that they drill a disproportionately large number of exploratory wells, and that these are frequently in areas in which relatively little exploration has previously occurred.[51] Their contribution to the search for new gas reserves is therefore significant, but it is made at correspondingly greater financial risks and at higher unit costs. The record before the Commission included evidence that, for this and other reasons, small producers have regularly suffered higher percentages of dry wells, and higher average costs per Mcf of production.[52] At the same time, the Commission found that small producers are the source of only a minor share of the total national gas production, and that the prices they have

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250 of the filing producers in the Permian Basin, leaving some 40 large producers. Under this definition, there are some 2,000 small producers in the United States, and 75 large producers. 34 F. P. C., at 235. See also Federal Power Commission, Sales by Producers of Natural Gas to Natural Gas Pipeline Companies 1963, 1–6 (1966).

[50] The examiner observed that the "basic difference between the small and the large producer is that the risks of the business are materially different for each." 34 F. P. C., at 360. Compare 1 Joint Appendix 318–319, 328–332.

[51] These questions were discussed at length in testimony before the examiner on behalf of the Texas Independent Producers and Royalty Owners Association, and others. See generally 5 Joint Appendix 1655–1714, 1773–1787; 1 *id.*, at 224–232, 255. And see Supplement to Joint Appendix 3s–6s.

[52] The examiner stated that small producers had "relatively larger dry hole expenses, a smaller proportion of geological and geophysical expenses, and a smaller proportion of lease acquisition expenditures"; he added that they had relatively larger depletion, depreciation, and amortization expenses. 34 F. P. C., at 361. The examiner also found that the "ratios of income available for income taxes, cash dividends, and working capital to net investment were 7.8, 2.5 and 7.4 for the large producers, small producers and for the weighted average." *Ibid.* See also testimony at 3 Joint Appendix 1114–1116.

received have followed closely those obtained by the larger producers.[53]

The Commission reasoned that, in these circumstances, carefully selected special arrangements for small producers would not improperly increase consumer prices. Moreover, it concluded that such exemptions might usefully both streamline the administrative process and strengthen the small producers' financial position.[54] The Commission provided two forms of special relief: first, it released small producers from the requirement that quality adjustments be made in price; [55] and second, it commenced a rule-making proceeding intended to relieve them from various filing and reporting obligations. See 34 F. P. C. 434. The Commission asserted that the consequences for consumer prices of the first would be *de minimis;* it expected that the second would measurably reduce the small producers' regulatory expenses.[56]

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[53] The Commission found that they provide only about 15% of the total supply of natural gas moving in interstate commerce, and that "they usually cannot obtain more for their gas than the regulated price we fix for the major producers." 34 F. P. C., at 234. And see *id.*, at 363. On the other hand, the Commission noted that in specific situations the small producers might have a very important portion of the relevant market. *Id.*, at 235. The examiner indicated that "[f]ewer than 50" large producers sell 85% of the gas sold from the Permian Basin under the Commission's jurisdiction. *Id.*, at 361.

[54] It should be noted that the small producers did not at first wish any special exemptions; they evidently feared that any such exemptions might cause the Commission to ignore their difficulties, and ultimately perhaps to permit them to be priced out of the industry. These discussions may be traced at 5 Joint Appendix 1692–1714.

[55] Correspondingly, the small producers need not take quality adjustments into account for purposes of refunds, unless they wish to take advantage of upward price adjustments because of high Btu content. 34 F. P. C., at 233.

[56] It is pertinent that the Commission estimated regulatory expenses, for purposes of the calculation of area maximum rates, at 0.14¢ per Mcf. The Commission stated that "no participant dis-

We conclude that these arrangements did not exceed the Commission's statutory authority. We recognize that the language of §§ 5 and 7 is without exception or qualification, but it must also be noted that the Commission is empowered, for purposes of its rules and regulations, to "classify persons and matters within its jurisdiction and prescribe different requirements for different classes of persons or matters." § 16, 15 U. S. C. § 717*o*. The problems and public functions of the small producers differ sufficiently to permit their separate classification, and the exemptions created by the Commission for them are fully consistent with the terms and purposes of its statutory responsibilities. It is not without relevance that this Court has previously expressed the belief that similar arrangements would ameliorate the Commission's administrative difficulties. See *Federal Power Commission* v. *Hunt*, 376 U. S. 515, 527.

Finally, we consider one additional question. Certain of the producers have urged that, having adopted a system of area regulation, the Commission improperly designated the Permian Basin as a regulatory area. It is contended that the Commission failed to provide appropriate opportunities for briefing and argument on questions of the size and composition of the area. We must, before considering the rate structure devised for the Permian Basin by the Commission, examine this contention.

The Commission's designation of the Permian Basin as a regulatory area stemmed from its Statement of General Policy, issued September 28, 1960. 24 F. P. C.

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putes its inclusion . . . ." 34 F. P. C., at 197. In contrast, it has been estimated that the total costs to producers of the Commission's regulation are some 1.164¢ per Mcf. Of this total, 0.039¢ are said to arise from administration, 0.809¢ from delay, and 0.316¢ from contingencies. See Gerwig, Natural Gas Production: A Study of Costs of Regulation, 5 J. Law & Econ. 69, 85, 86, 88.

818. The Commission there announced its intention to regulate producers' interstate sales through the imposition of maximum area prices; it provided, for this purpose, a provisional system of guideline prices for the principal producing areas. The Commission averred that these areas, although "not necessarily in complete accord with geographical and economic factors," are "convenient and well-known." *Id.*, at 819. It declared that, as "experience and changing factors" require, it was prepared to alter the areas to eliminate any inequities. *Ibid.*

On December 23, 1960, the Commission ordered the institution of this proceeding, for which it merged three of the producing areas separately listed by the Statement of General Policy. 24 F. P. C. 1121. It unequivocally announced that "no useful purpose would be served at this time by delaying the discharge of our primary responsibility . . . by entertaining issues . . . that the areas we have delineated . . . might be inappropriate for the rate making purposes." *Id.*, at 1122. It appears that no hearings were conducted, and no evidence taken, on the propriety of the areas thus designated by the Commission for inclusion in this proceeding.

We do not doubt that significant economic consequences may, in certain situations, result from the definition of boundaries among regulatory areas. The calculation of average costs might, for example, be influenced by the inclusion or not of a given group of producers; and the loss or retention of a price differential between regulatory areas might prove decisive to the success of marginal producers. Nonetheless, we hold that the Commission did not abuse its statutory authority by its refusal to complicate still further its first area proceeding by inclusion of issues relating to the proper size and composition of the regulatory area.

It must first be emphasized that the regulatory area designated by the Commission was evidently both convenient and familiar. There is no evidence before us, and the producers have not alleged, that the Permian Basin, as it was defined by the Commission, does not fit either with prevailing industry practice or with other programs of state or federal regulation.[57] Moreover, the Commission was already confronted by an extraordinary variety of difficult issues of first impression; it quite reasonably preferred to simplify, so far as possible, its proceedings. Finally, it is not amiss to note that the Commission evidently has more recently permitted consideration of similar questions in area proceedings. Compare *Area Rate Proceeding* (*Hugoton-Anadarko Area*), 31 F. P. C. 888, 891. We assume that, consistent with this practice and with the terms of its Statement of General Policy, the Commission now would, upon an adequate request, permit interested parties to offer evidence and argument on the propriety of modification of the Permian Basin regulatory area. We hold only that the Commission was not obliged, in the circumstances of this case, to include among the disputed issues questions of the proper size and composition of the regulatory area.

We therefore conclude that the Commission did not, in these proceedings, violate pertinent constitutional limitations, and that its adoption of a system of area

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[57] It is pertinent that much of the cost and other data upon which the Commission relied reflected national, and not area or local, circumstances. Further, the Commission found that production costs in the Permian Basin did not "vary sufficiently from the national average to warrant a different treatment . . . ." 34 F. P. C., at 191. Moreover, no party offered a comprehensive cost study premised on a larger Permian Basin, although certain information relevant to adjacent areas was presented. See 1 Joint Appendix 37–41; 6 *id.*, at 15e. But see 1 *id.*, at 242–244.

price regulation, supplemented by provisions for a moratorium upon certain price increases and for exceptions for smaller producers, did not abuse or exceed its authority. We accordingly turn to various questions that have been raised respecting the propriety of the rate structure devised by the Commission for the Permian Basin.

IV.

It is important first to delineate the criteria by which we shall assess the Commission's rate structure.[58] We must reiterate that the breadth and complexity of the Commission's responsibilities demand that it be given every reasonable opportunity to formulate methods of regulation appropriate for the solution of its intensely practical difficulties. This Court has therefore repeatedly stated that the Commission's orders may not be overturned if they produce "no arbitrary results." *FPC* v. *Natural Gas Pipeline Co., supra,* at 586; *FPC* v. *Hope Natural Gas Co., supra,* at 602. Although neither law nor economics has yet devised generally accepted standards for the evaluation of rate-making orders,[59] it must, nonetheless, be obvious that reviewing courts will require criteria more discriminating than justice and arbitrariness if they are sensibly to appraise the Commission's orders. The Court in *Hope* found appropriate criteria by inquiring whether "the return to the equity owner [is]

[58] The rate structure is summarized above, at 7–12.

[59] Economists have frequently proved more candid about these difficulties. Social welfare and public interest standards have been described as "almost unique in the extreme vagueness of [their] ultimate verbal norm." Bonbright, *supra,* at 27. Similarly, it is said that no writer "whose views on public utility rates command respect purports to find a single yardstick by sole reference to which rates that are reasonable or socially desirable can be distinguished from rates that are unreasonable or adverse to the public interest." *Id.,* at 67. But compare *National Broadcasting Co.* v. *United States,* 319 U. S. 190, 216.

commensurate with returns on investments in other enterprises having corresponding risks," and whether the return was "sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital." *Id.*, at 603. And compare *S. W. Tel. Co.* v. *Public Serv. Comm.*, 262 U. S. 276, 290–292 (dissenting opinion). But see Edgerton, Value of the Service as a Factor in Rate Making, 32 Harv. L. Rev. 516. These criteria, suitably modified to reflect the special circumstances of area regulation, remain pertinent, but they scarcely exhaust the relevant considerations.

The Commission cannot confine its inquiries either to the computation of costs of service or to conjectures about the prospective responses of the capital market; it is instead obliged at each step of its regulatory process to assess the requirements of the broad public interests entrusted to its protection by Congress. Accordingly, the "end result" [60] of the Commission's orders must be measured as much by the success with which they protect those interests as by the effectiveness with which they "maintain credit and . . . attract capital."

It follows that the responsibilities of a reviewing court are essentially three. First, it must determine whether the Commission's order, viewed in light of the relevant facts and of the Commission's broad regulatory duties, abused or exceeded its authority. Second, the court

[60] This phrase was taken by the Court of Appeals as the substance of the opinion of the Court in *Federal Power Commission* v. *Hope Natural Gas, supra*. The court contrasted unfavorably the Commision's assertion that it had found a "fair relationship" between the consumer interests and the producers' costs. See 34 F. P. C., at 1074; 375 F. 2d, at 34. We are unable to find in the verbal differences between these two phrases any objection to the Commission's orders. The Commission's exercise of its regulatory authority must be assessed in light of its purposes and consequences, and not by references to isolated phrases from previous cases.

must examine the manner in which the Commission has employed the methods of regulation which it has itself selected, and must decide whether each of the order's essential elements is supported by substantial evidence. Third, the court must determine whether the order may reasonably be expected to maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed, and yet provide appropriate protection to the relevant public interests, both existing and foreseeable. The court's responsibility is not to supplant the Commission's balance of these interests with one more nearly to its liking, but instead to assure itself that the Commission has given reasoned consideration to each of the pertinent factors. Judicial review of the Commission's orders will therefore function accurately and efficaciously only if the Commission indicates fully and carefully the methods by which, and the purposes for which, it has chosen to act, as well as its assessment of the consequences of its orders for the character and future development of the industry. We are, in addition, obliged at this juncture to give weight to the unusual difficulties of this first area proceeding; we must, however, emphasize that this weight must significantly lessen as the Commission's experience with area regulation lengthens. We shall examine the various issues presented by the rate structure in light of these interrelated criteria.

The first issue is whether the Commission properly rejected the producers' contention that area rates should be derived from field, or contract, prices. The producers have urged that prevailing contract prices provide an accurate index of aggregate revenue requirements, and that they are an appropriate mechanism for the protection of consumer interests. The record before the Commission, however, supports its conclusion that competition cannot be expected to reduce field prices in the

Permian Basin to the "lowest possible reasonable level consistent with the maintenance of adequate service in the public interest." *Atlantic Rfg. Co.* v. *Public Service Comm'n*, 360 U. S. 378, 381.

The field price of natural gas produced in the Permian Basin has in recent years steadily and significantly increased.[61] These increases are in part the products of a relatively inelastic supply and steeply rising demand; but they are also symptomatic of the deficiencies of the market mechanism in the Permian Basin. Producers' contracts have in the past characteristically included indefinite escalation clauses. These clauses, in combination with the price leadership of a few large producers,[62] and with the inability or unwillingness of interstate pipelines to bargain vigorously for reduced prices,[63] have

[61] The Commission found that the 2.8¢ per Mcf paid as an average price in 1947 had risen to 9.0¢ in 1954, and to 13.8¢ in 1960. In 1960, El Paso, the dominant pipeline company in the Basin, renegotiated its contracts and offered prices ranging from 13.5 to 17¢ per Mcf. 34 F. P. C., at 182. The examiner pointed out that between 1947 and 1960, the average price paid nationally by pipelines trebled, from 4.95 to 15.61¢ per Mcf. *Id.*, at 312. And see 2 Joint Appendix 423–432.

[62] It appears that five producers were responsible in 1960 for more than one-half of all the natural gas sold from the Basin under the Commission's regulation. Fifteen producers accounted for almost three-fourths of the sales. See Memorandum of the Texas Independent Producers and Royalty Owners Association, 5 Joint Appendix 1775, 1780. See also Analysis of Independent Producer Rate Schedules, 6 Joint Appendix 275e–293e. These questions are very usefully discussed by distributor witness Kahn at 2 Joint Appendix 410–432. He notes the significance of "a sharply rising demand operating on a sluggishly responding supply," *id.*, at 423, but also emphasizes the importance of the escalation clauses and of various market imperfections.

[63] The Commission stated that "the entire history of pipeline purchasing activity, since the end of the El Paso monopoly in the Permian Basin, has been characterized by the overriding needs of the pipelines to contract for the large blocks of uncommitted re-

created circumstances in which price increases unconnected with changes in cost may readily be obtained. These market imperfections, operative despite an "essentially monopsonistic environment," have accentuated the consequences of inelastic supply and sharply rising demand.[64] Once an increase has been obtained by the larger producers, the escalation clauses have guaranteed similar increases to others.[65] In contrast, consumers have been left without effective protection against steadily rising prices. Their alternative sources of energy are in practice few, and the demand for natural gas, particularly in California, is therefore relatively unresponsive to price increases.[66] The consumer is thus obliged to rely

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serves essential to maintain their competitive position in developing markets . . . and their inability to accomplish this objective except at ever increasing prices." 34 F. P. C., at 182. It is noteworthy that, despite the obvious importance of these proceedings, the pipeline companies did not take an active part here, in the Court of Appeals or before the Commission. See also 2 Joint Appendix 423–432. But see 4 *id.*, at 1384–1388.

[64] The phrase is Commissioner O'Connor's. 34 F. P. C., at 252 (opinion concurring and dissenting on limited issue). It is proper to note that he would have made much wider use of field prices for the calculation of the area rates. Monopsony is the term used to describe a situation in which the relevant market for a factor of production is dominated by a relatively small number of purchasers. See J. Robinson, The Economics of Imperfect Competition 215 (1933). The relevant market here is that for uncommitted reserves. See 2 Joint Appendix 410. Finally, for a general examination of the usefulness of the competitive model for regulation, see Bonbright, *supra*, at 106–108.

[65] It should be observed that the significance of the escalation clauses will presumably be diminished by the Commission's series of orders restricting their use.

[66] Some 85% of the gas sold in interstate commerce from the Permian Basin is ultimately consumed in California. 34 F. P. C., at 174, 312. The demand for natural gas among residential and commercial consumers, once they have purchased the necessary equipment, is relatively inelastic. *Id.*, at 313. The demand among

upon the Commission to provide "a complete, permanent and effective bond of protection from excessive rates and charges." *Atlantic Rfg. Co.* v. *Public Service Comm'n*, *supra*, at 388.

We do not now hold, and the Commission has not suggested,[67] that field prices are without relevance to the Commission's calculation of just and reasonable rates under § 5 (a). The records in subsequent area proceedings may more clearly establish that the market mechanism will adequately protect consumer interests.[68] We hold only that, on this record, the Commission was not compelled to adopt field prices as the basis of its computations of area rates.

We next examine the Commission's decision to create two maximum area rates for the Permian Basin. Under the Commission's rate structure, the applicable maximum price for a producer's sale is determined both by the moment at which the gas was first dedicated to the interstate market, and by the method by which the gas was produced. It follows that two producers, simultaneously

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industrial consumers is more responsive to price, but restrictions in California on the use of various industrial fuels have left industrial demand less responsive to price there than in other parts of the country. *Id.*, at 313–314.

[67] Indeed, the Commission explicitly stated that "[w]e recognize that the history of negotiated prices in the area is an important element to be considered in reaching our decision." 34 F. P. C., at 181.

[68] We note that economists have sometimes concluded that the market mechanism works satisfactorily in the natural gas industry. "There is . . . no question but that the field price of gas in the United States is competitively determined." Adelman, *supra*, at 39. See also E. Neuner, The Natural Gas Industry 125–134, 238–290 (1960). In contrast, Professor Kahn said of oil and gas that "few other industries in our entire economy . . . are so insulated . . . from the normal forces of the market." 2 Joint Appendix 607. But see 1 *id.*, at 217–218, 280–281. And see R. Hooley, Financing the Natural Gas Industry 5–25 (1961).

offering gas of identical quality and Btu content, may be confronted by different maximum prices.

The premises of this arrangement are two. First, the Commission evidently believed that price should be employed functionally, as a tool to encourage the production of appropriate supplies of natural gas. A price is thus just and reasonable within the meaning of §§ 4 (a) and 5 (a) not merely because it is "somebody's idea of return on a 'rate-base,'" [69] but because it results in satisfactory programs of exploration, development and production.

Second, the Commission concluded that price could usefully serve as an incentive to exploration and production only if it were computed according to the method by which gas is produced. Natural gas produced jointly with oil is necessarily a relatively unimportant by-product. The value of oil-well gas is on average only one-seventeenth that of the oil with which it is produced. See 34 F. P. C., at 322. It cannot be separately sought or independently produced; its production is effectively restricted by state regulations intended to encourage the conservation of oil. Accordingly, the supply of oil-well gas is, as the examiner observed, "almost perfectly inelastic." *Id.*, at 323.

On the other hand, gas-well gas is produced independently of oil, and of state restrictions on oil production. More important, the Commission found that a separate search can now be conducted for gas reservoirs; cumulative drilling experience permits at least the larger producers to direct their programs of exploration and development to the search for gas.[70] The supply of gas-

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[69] *Colorado Interstate Co.* v. *Federal Power Commission*, 324 U. S. 581, 612 (concurring opinion).

[70] The examiner found that the larger producers could now predict with high accuracy whether drilling in a particular area would be likely to produce associated or unassociated gas. 34 F. P. C., at 325–329. This appears primarily to be the consequence of

well gas is therefore relatively elastic, and its price can meaningfully be employed by the Commission to encourage exploration and production. The Commission reasoned that a higher maximum rate for gas-well gas dedicated to interstate commerce after the approximate moment at which a separate search became widely possible would provide an effective incentive.[71] Correspondingly, the Commission adopted a relatively low price for all other natural gas produced in the Permian Basin, since price could not serve as an incentive, and since any price above average historical costs, plus an appropriate return, would merely confer windfalls.

We find no objection under the Natural Gas Act to this dual arrangement. We have emphasized that courts are without authority to set aside any rate adopted by the Commission which is within a "zone of reasonableness." *Federal Power Commission* v. *Natural Gas Pipeline Co.*, *supra*, at 585. The Commission may, within this zone, employ price functionally in order to achieve relevant regulatory purposes; it may, in particular, take fully into account the probable consequences of a given price level for future programs of exploration and production. Nothing in the purposes or history of the Act forbids the Commission to require different prices for different sales, even if the distinctions are unrelated to quality, if these arrangements are "necessary or appropriate to carry out the provisions of the Act." § 16; 15 U. S. C. § 717*o*. We hold that the statutory "just and reasonable" stand-

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accumulated experience, and not of any improvement in technology. See also 2 Joint Appendix 558, 581; 1 *id.*, 56, 307–308. Useful statistical evidence of predictability may be found in producer testimony. See 3 *id.*, at 952–955, 963, 965–967, 1079–1080. And see 7 *id.*, at 572e–575e. It should be noted that the Commission's staff denied that gas could be separately sought. 3 *id.*, at 933–934.

[71] Estimates of the moment at which directional search became possible varied; one witness testified that Phillips regarded January 1, 1959, as an appropriate date of calculation. 1 Joint Appendix 56.

ard permits the Commission to require differences in price for simultaneous sales of gas of identical quality, if it has permissibly found that such differences will effectively serve the regulatory purposes contemplated by Congress.

The Commission's responsibilities include the protection of future, as well as present, consumer interests. It has here found, on the basis of substantial evidence, that a two-price rate structure will both provide a useful incentive to exploration and prevent excessive producer profits. In these circumstances, there is no objection under the Natural Gas Act to the price differentials required by the Commission.

The symmetry of the Commission's incentive program is, however, marred. The Commission held in 1965 that the higher maximum rate should be applicable to gas-well gas committed to interstate commerce since January 1, 1961. It is difficult to see how the higher rate could reasonably have been expected to encourage, retrospectively, exploration and production that had already occurred. There is thus force in Commissioner Ross' contention that this arrangement is not fully consistent with the logic of the two-price system.[72]

Nonetheless, we are constrained to hold that this was a permissible exercise of the Commission's discretion. The Commission believed that its Statement of General Policy, issued September 28, 1960, had created reasonable expectations among producers that higher rates would thereafter be permitted for initial filings under § 7.[73] The Commission evidently concluded that fairness

[72] See 34 F. P. C., at 273. But contrast the testimony of distributor witness Kahn, who recognized that it would be "in some measure arbitrary" to give the lower price to gas wells that began production after 1960 but before the Commission's final decision in these proceedings. 2 Joint Appendix 635.

[73] The Statement provided a guideline price of 16¢ per Mcf for initial filings, and 11¢ per Mcf for previously committed gas. 24

obliged it to satisfy, at least in part, those expectations. We must also recognize that an unexpected downward revision of the guideline price for initial filings, with accompanying refunds, might have seriously diminished the producers' confidence in interstate prices, and perhaps threatened the future interstate supply of natural gas.[74] We can assume that the Commission gave attention to this possibility. Compare 34 F. P. C., at 188. These factors provide a permissible basis for this exercise of the Commission's authority.[75]

We must next examine the methods by which the Commission reached the two maximum rates it created for gas produced in the Permian Basin. The Commission justified its adoption of a two-price rate structure by reliance upon functional pricing; it suggested that two prices, with an appropriate differential, may be used so as both to provide an incentive to exploration and to restrict to reasonable levels producers' profits. In turn, it computed the two area maximum prices directly from costs of service, without allowances for noncost factors. The price differential which the Commission expects to serve as an incentive is the product of differences in the time periods and geographical areas for which costs were

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F. P. C., at 820. The Commission indicated that this was in recognition of "economic factors." *Id.*, at 819.

[74] It is pertinent that Gerwig found that a premium of 1.16¢ per Mcf is necessary before producers rationally enter the interstate market. Gerwig, *supra*, at 85. See also Kitch, The Permian Basin Area Rate Cases and the Regulatory Determination of Price, 116 U. Pa. L. Rev. 191, 207. Compare Johnson, Producer Rate Regulation in Natural Gas Certification Proceedings: CATCO in Context, 62 Col. L. Rev. 773, 784, n. 61. Finally, see the testimony of producer witness Foster, 1 Joint Appendix 142–144.

[75] We see no objection to the Commission's preference for January 1, 1961, instead of December 23, 1960, the date on which it issued the order commencing these proceedings. This choice was adequately justified by administrative convenience.

computed, and not of noncost additives to cost components. Finally, the Commission, by its adoption of a moratorium until January 1, 1968, created a temporary price freeze in the Permian Basin.[76]

Although we would expect that the Commission will hereafter indicate more precisely the formulae by which it intends to proceed, we see no objection to its use of a variety of regulatory methods. Provided only that they do not together produce arbitrary or unreasonable consequences, the Commission may employ "any formula or combination of formulas" it wishes, and is free "to make the pragmatic adjustments which may be called for by particular circumstances." *Federal Power Commission* v. *Natural Gas Pipeline Co., supra,* at 586. We have already considered the Commission's adoption of a two-price system and of a moratorium, and have concluded that they are each reasonably calculated to achieve appropriate regulatory purposes. It remains now to examine its computation of the area maximum prices from the producers' costs of service.

The Commission derived the maximum rate for new gas-well gas from composite cost data intended to evidence the national costs in 1960 of finding and producing gas-well gas. It reasoned that these costs should be computed from national, and not area, data because, first, the larger producers conduct national programs of exploration, and, second, "much, if not most, of the relevant information" [77] was available only on a national

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[76] It should be observed that the witness chiefly responsible for the contrivance of the two-price system ultimately adopted by the Commission, see 2 Joint Appendix 510–513, 576–585, 601–611, has elsewhere described the need for close restraints on increases in the price for natural gas. Kahn, Economic Issues in Regulating the Field Price of Natural Gas, 50 Am. Econ. Rev. 506, 510–514. See also Kitch, *supra,* at 211–212.

[77] 34 F. P. C., at 191. And see *id.,* at 339–340.

basis. It held, in addition, that costs in the Permian Basin did not "vary sufficiently from the national average to warrant a different treatment . . . ." 34 F. P. C., at 191. The Commission found that 1960 cost data should be used, and historical data disregarded, because only relatively current cost data would adequately guarantee an effective incentive for future exploration and production. The Commission was obliged to obtain the relevant cost data from a variety of sources. Natural gas producers have not yet been required to adopt any uniform system of accounts, and no private or public agency had in 1965 collected all the pertinent information. Much of the data was taken from nationally published statistics;[78] the balance was derived from questionnaires completed by the producers. The Commission concluded that these sources "in combination provide an adequate basis for the costs we have found." *Ibid.*

The maximum just and reasonable rate for all other Permian Basin gas was calculated from cost data intended to reflect the historical costs of gas-well gas produced in 1960 in the Permian Basin. The examiner had computed this rate by essentially the same method he had used for new gas-well gas, with certain cost components adjusted by back-trending. The Commission's staff, on the other hand, offered a comprehensive study of historical costs of service. The Commission adopted both methods, using the examiner's back-trended cost

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[78] It should be noted that the parties proffered a list of sources of information, to which the examiner gave his approval. See 1 Joint Appendix 291–305, 309–310. These were said by the parties to be "recognized, published statistical data sources." *Id.*, at 292. The Commission described them as "well-recognized and authoritative." 34 F. P. C., at 191. Nonetheless, careful efforts were made to determine whether these and other sources of evidence, including the producers' questionnaires, were, as to the various cost components, accurately representative of the relevant groups of producers. See, *e. g.*, *id.*, at 377, 378, 380, 381, 384, 387, 392, 393.

computations as a check upon the accuracy of the staff's presentation.

The Commission reasoned that excessive producer profits could be minimized only if the rate for flowing gas were derived from the most precise available evidence of actual historical costs. It therefore held that these costs should be taken from area, and not national, data.

The Commission's staff obtained the data necessary for its computation of historical costs from questionnaires completed by producers. The information used by the staff, and ultimately adopted by the Commission, was taken from questionnaires submitted by 42 major producers, which together account for 75% of all the gas produced in the Basin, and 85% of all the gas-well gas. Nonetheless, some two-thirds of all the gas produced in the Permian Basin is oil-well gas, and Sun Oil estimates that the staff's gas-well gas data was thus applicable only to some 15.3% of the total production of natural gas in the Basin in 1960.[79]

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[79] Three sets of questionnaires were used. Appendix A was applicable to all producers, and concerned chiefly drilling costs. Appendix B was required of large producers, and concerned costs, revenues and production. Appendix C was a simplified version of Appendix B, which small producers were permitted to use. The producers have argued vigorously that these questionnaires did not provide a sufficient basis for the Commission's findings. We cannot agree. The Commission reasonably concluded, as had the examiner, that the Appendix C questionnaires received from small producers were not necessarily representative. 34 F. P. C., at 214. And see 3 Joint Appendix 1117–1118. Moreover, the addition of the Appendix C data from the small producers would evidently not have produced a significant change in the ultimate cost components. See 34 F. P. C., at 214, 392–393, 400. Further, the Commission found that the responses to the Appendix B questionnaires received from 25 small producers would not have "change[d] the results." *Id.*, at 214, n. 34. Of the 43 large producers that filed Appendix B questionnaires, the staff and Commission disregarded only one, which had not been properly completed. See generally 2 Joint Appendix 731–

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We hold that the Commission, in calculating cost data for the two maximum rates by differing geographical bases and time periods, did not abuse its authority. The Commission's use of separate sources of data for the two rates permitted the creation of a price differential between them without the inclusion of noncost components. Its selections of time periods and geographical bases were entirely consistent with the logic of its system of incentive pricing. In these circumstances, we can find no tenable objection to this aspect of the Commission's rate structure.

It is further contended that the Commission impermissibly used flowing gas-well gas cost data to calculate the maximum rate for old gas, thereby disregarding entirely the costs of gas produced in association with oil. The Commission's explanation was essentially pragmatic. It reasoned that the uncertainties of joint cost allocation preclude accurate computations of the cost of casinghead and residue gas. Further, the Commission averred that it is administratively imperative to simplify, so far as possible, the area rate structure. The Commission regarded its adoption of a single area maximum price for all gas, except new gas-well gas, its residue and gas-cap gas, as "an important step toward simplified and realistic price regulation." 34 F. P. C., at 211.

748; 3 *id.*, at 753–761. In these circumstances, the Commission concluded, we think reasonably, that "the data provided by the major producers with respect to their Permian production was fully representative of area costs . . . ." 34 F. P. C., at 214. This Court has repeatedly held that administrative agencies may "proceed on a group basis . . . on 'evidence which the Commission assumed was typical in character, and ample in quantity' to justify its findings . . . ." *Chicago & N. W. R. Co.* v. *Atchison, T. & S. F. R. Co.*, 387 U. S. 326, 341, quoting *New England Divisions Case, supra*, at 196–197. The Commission has here reasonably found that the evidence before it satisfied these requirements; we therefore find no objection.

We cannot say that these arrangements are impermissible. There is ample support for the Commission's judgment that the apportionment of actual costs between two jointly produced commodities, only one of which is regulated by the Commission, is intrinsically unreliable.[80] It is true that certain of the costs of gas-well gas must also be apportioned, but the Commission reasonably concluded that these difficulties are relatively less severe.[81] The Commission was, in addition, entitled to give great weight to the administrative importance of a simplified rate structure. Finally, it is relevant that the Commission found that the cost of casinghead and residue gas could not be higher, and, if exploration and development costs are realistically discounted, must surely be lower than the costs of flowing gas-well gas.[82] These considerations in combination

[80] See generally the examiner's discussion, 34 F. P. C., at 393–400. Economists have described these difficulties with repetitive pungency. "To make laborious computations purporting to divide [such] costs is 'nonsense on stilts,' and has no more meaning than the famous example of predicting the banana crop by its correlation with expenditures on the Royal Navy." Edelman, *supra*, at 25. See also Machlup, *supra*, at 21; Bonbright, *supra*, at 339–342. Compare Eckstein, Natural Gas and Patterns of Regulation, 36 Harv. Bus. Rev. 126, 129–133; and Kahn, *supra*, at 510–514.

[81] By one estimate, the costs of nonassociated gas are 45% separate, 31% joint, and 24% common. See 34 F. P. C., at 339. All of the costs of associated gas are joint. *Ibid.* But see Kitch, *supra*, at 202.

[82] 34 F. P. C., at 1072. None of the distributors or public agencies before the Court, except *amici*, have argued that this permits excessively generous returns to producers. Indeed, representatives of the consumers who ultimately purchase most of the gas produced in the Permian Basin have urged us to avoid "long extensive delays" and to affirm the Commission's orders in their entirety. See, *e. g.*, Brief for the City of Los Angeles 6; Joint Brief for the City of San Diego and the City and County of San Francisco 24; Brief for People of the State of California 63. These parties did not petition to the Court of Appeals for review of the Commission's

warranted the Commission's judgment that a single area maximum price for all gas other than new gas-well gas should be imposed, and that this maximum rate should be derived entirely from the historic costs of flowing gas-well gas.

We turn now to the Commission's computation of the proper rate base. The Commission's method here differed significantly from that frequently preferred by regulatory authorities. It did not use a declining rate base and return, but instead computed an average net production investment, to which it applied a constant rate of return. The Commission assumed for this purpose that a gas well depletes at a uniform rate, and that it is, on average, totally depleted in 20 years. It found that the annual capital-recovery cost, including depletion, depreciation, and amortization, was 3.95¢ per Mcf. Allowing one year for a lag between investment and first production, the Commission obtained an average production investment of 43.45¢ per Mcf. The proper return per Mcf was then calculated by multiplying this figure by the rate of return.

The producers argue that this has the effect of postponing revenue, and thus discounting its present value; they suggest that the Commission should properly have

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orders, and participated below only as intervenors in full support of the Commission's position. Even assuming *arguendo* that these questions are not now foreclosed by § 19 (b), we can find no basis on which to set aside the area rates as excessive. As we shall show below, the rate of return permitted the producers does not substantially exceed that ordinarily allowed to pipelines. Further, it must be recalled that the area *maximum* rates were, even before adjustment for quality and Btu deficiencies, intended to approximate *average* unit costs. Finally, we note that the Commission's area rate for new gas-well gas, after adjustment for average quality deficiencies, very nearly equals that originally proposed by distributor and consumer representatives. Compare 34 F. P. C., at 343, and at 1073. We cannot say that the Commission's rates are above the "zone of reasonableness" permitted by the Natural Gas Act.

employed a declining investment base and return. This is a question peculiarly within the Commission's discretion, and, while the method adopted by the Commission was evidently less favorable to the producers than various other possible formulae, we cannot hold that it was arbitrary or unreasonable.

We next consider whether the rate of return adopted by the Commission was a permissible exercise of its regulatory authority. The Commission first asserted that rates of return must be assessed by a comparable-earnings standard. Under such a standard, earnings should be permitted that are "equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties." *Bluefield Co.* v. *Public Service Comm.*, 262 U. S. 679, 692; *Federal Power Commission* v. *Hope Natural Gas Co.*, *supra*, at 603. Although other standards might properly have been employed,[83] the Commission's decision to examine comparable earnings was fully consistent with prevailing administrative practice, and manifestly was not an abuse of its authority.

The Commission relied for purposes of comparison chiefly upon the rates of return that have recently been permitted to the interstate pipelines. It found that pipelines had been given returns of 6.0 to 6.5% on net investment, with a yield on equity of 10 to 12%.[84] The Commission noted that producers characteristically have

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[83] These questions are usefully discussed in Bonbright, *supra*, at 240–283. See also the Commission's discussion of the true yield method. 34 F. P. C., at 202. Compare 4 Joint Appendix 1267, 1406–1416. And see the Initial Decision of the Presiding Examiner in *Area Rate Proceeding* (*Southern Louisiana Area*), *No. AR61–2*, issued December 30, 1966, at 75–85.

[84] 34 F. P. C., at 201. Compare *id.*, at 343–352. And see for estimates of more recent equity allowances, Brief for the Federal Power Commission 144, n. 16.

less long-term debt than pipelines,[85] and that the financial risks of production are somewhat greater than those of transmission.[86] It reasoned that these differences warranted a more generous rate of return for producers. In addition, the Commission stated that the risk of finding gas of less than pipeline quality, created by the Commission's promulgation of quality and Btu standards, should be reflected in the rate of return. Finally, the Commission sought to determine the rate of return recently earned by producers of natural gas. It found that accurate rates of return could not be calculated with assurance, although the Commission's staff offered evidence of an average return for nine companies over five years of 12.4% on net investment.[87] The Commission concluded that, despite its statistical deficiencies, this and similar evidence must be given "heavy consideration in the decisional process." 34 F. P. C., at 203.

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[85] The examiner found that nonintegrated producers had an average debt of approximately 12%. The pipelines were found to have debts "sometimes as large as 70 percent of total capitalization . . . ." 34 F. P. C., at 345. See also contrasting testimony at 1 Joint Appendix 173–177; and 2 *id.*, at 614–626. It is proper to observe that it has sometimes been argued that the leverage of high borrowings itself creates certain financial risks. But see G. Stigler, Capital and Rates of Return in Manufacturing Industries 64, n. 15 (1963). Finally, it should be noted that risk has on occasion been regarded as cause for a reduction of the rate of return. See C. Hardy, Risk and Risk-bearing, 37–38 (1931).

[86] As will appear below, we find the Commission's discussion of relative financial risks imprecise. There is, however, a plain statement in the Commission's opinion to the effect that exploration and production are financially more hazardous than transmission. See 34 F. P. C., at 201. The Commission did not indicate clearly whether it considered production taken in the aggregate as more hazardous than the affairs of an individual pipeline company, or indeed even whether it considered such aggregate calculations relevant.

[87] See the discussion at 34 F. P. C., at 203–204. And see *id.*, at 349–352. Finally, see 3 Joint Appendix 850–936.

On balance, the Commission selected 12% as the proper rate of return for gas of pipeline quality. We think that this judgment was supported by substantial evidence, and that it did not exceed or abuse the Commission's authority. The evidence before the Commission fairly suggests that this rate will be likely to "maintain [the producers'] financial integrity, to attract capital, and to compensate [their] investors for the risks assumed . . . ." *Federal Power Commission* v. *Hope Natural Gas Co., supra,* at 605. Further, the distributors and public agencies before the Court have not suggested, and we find no reason to believe, that this return will exceed the proper requirements of the industry.[88] Certainly, as we shall show below, this return is no more than comparable to that characteristically allowed interstate pipelines.

Nonetheless, there remains one further issue essential to an accurate appraisal of the return permitted by the Commission. The Commission's computation of the rate of return was specifically premised in part on the additional financial risks created for producers by the Commission's promulgation of quality and Btu standards.[89] Its opinion in these proceedings included a series of

[88] But see Kitch, *supra,* at 201. See also Stigler, *supra,* at 62–64.

[89] It has been argued with force that the producers were not given fair notice that the Commission might promulgate such standards. It appears that the Commission did not announce in terms that it might create quality standards, and that it tacitly denied a motion to consolidate this proceeding with a rule-making proceeding intended to devise national quality standards. We cannot say that the Commission impermissibly refused to complicate still further this proceeding by the addition of issues centering on national quality standards. Moreover, the general terms of the Commission's order commencing this proceeding reasonably encompassed questions of quality standards, 24 F. P. C. 1121, 1124, and we do not regard the Commission's denial of the consolidation motion as foreclosing the ultimate adoption of such standards. The producers' motion was premised on the desirability of national standards, and

specific quality standards.[90] The Commission ruled that gas that fails to satisfy these standards must be sold at prices lower than the applicable area maximum; the amount of the reduction necessary in each sale is to be initially determined by the parties, subject to review by the Commission. Further, natural gas with a Btu content of less than 1,000 per cubic foot must be sold at a price proportionately lower than the applicable area maximum, and gas with a Btu content of more than 1,050 per cubic foot may be sold at a price proportionately higher than the area maximum.[91] The

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explicitly recognized that prices and differences in quality "are so inextricably tied together that they cannot be meaningfully separated one from the other." 9 Joint Appendix 69d, 71d. We cannot hold that the Commission denied the producers fair notice that it might as a consequence of these hearings impose quality standards.

[90] It is argued vigorously that the standards adopted by the Commission lack substantial basis in the record. Emphasis is placed chiefly on the examiner's statement that it would be "probably impossible on this record . . . to establish a complete set of differentials for the various value and quality characteristics of gas." 34 F. P. C., at 368. See also 1 Joint Appendix 123–136. We believe this statement to be inapposite to the issues before us. The Commission did not create such a set of differentials; it merely posited a series of pipeline standards, and placed the responsibility for reaching specific price differentials upon the parties to each sale. It indicated that it would accept any agreement that appeared to be a good-faith effort to determine the pertinent processing costs. It should be noted that at least one witness testified that negotiation among the relevant parties is the proper method for measurement of processing costs. See 3 Joint Appendix 983. Further, various estimates of quality adjustments were provided by witnesses before the examiner. See 5 *id.*, at 1769–1771, 1867–1899, 1907–1908. We conclude that the Commission's findings on these questions are adequately supported by the record.

[91] Commissioner O'Connor argued forcefully in a concurring and dissenting opinion that the Commission's adoption of high and low Btu standards was unfair to producers. 34 F. P. C., at 267–268. The Court of Appeals indicated that it was unable to understand

Commission conceded that it could not precisely determine the revenue consequences of these adjustments, although its opinion denying applications for rehearing provided various estimates. It appears to be conceded that the quality of gas produced in the Basin is characteristically lower than the Commission's standards, and that the standards are therefore likely to be more significant than they might be in other producing areas.

The producers urge, and the Court of Appeals held, that this arrangement is doubly erroneous. First, it treats as a risk what properly is a cost, and thus evades the necessity of appropriate findings on the revenue consequences of the quality adjustments. Second, it reduces the rate of return actually permitted individual producers to an unascertainable figure of less than 12%, and thus prevents an accurate appraisal of its sufficiency. We find both suggestions unpersuasive.

We cannot now hold that it was impermissible for the Commission to treat the quality adjustments as a risk of production. It must be recalled that the Commission was in this first area rate case unable to determine with

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the reasons for the dual standard. 375 F. 2d, at 31. We agree that the Commission might have dealt more clearly with these questions, but we have found no basis on which we can set aside its judgment. The Commission found that, by prevailing practice, the minimum Btu standard in the Permian Basin was 1,000 per cubic foot; the average Btu content is, however, in a range of 1,034 to 1,042 per cubic foot. 34 F. P. C., at 223, 267–268. It concluded that it would require downward price adjustments only where Btu content is less than 1,000, and permit upward adjustment only where it exceeds 1,050 per cubic foot. Although this is evidently less favorable to producers than other possible formulae, we have found no evidence that suggests that it is arbitrary, or an abuse of the Commission's authority. Compare Initial Decision, *Area Rate Proceeding (Southern Louisiana Area), No. AR61–2,* issued December 30, 1966, at 180–183.

precision the average amount of the necessary price reductions, and that it thus would have been difficult to have included them as costs, as the Court of Appeals suggested. Further, we recognize that the Commission's method, premised on agreement between the parties to each sale, has at least the advantage of requiring discrete and accurate adjustments for each transaction. Finally, as we shall show below, treatment of these adjustments as risks of production did not in this case result in inadequate findings, and does not prevent proper appraisal of the rate of return permitted by the Commission. In any event, the Commission's discretion in such matters is necessarily broad, and its choice cannot be said to have abused its discretion.

The Commission estimated in its opinion denying applications for rehearing that the quality adjustments would result in average price reductions of from 0.7¢ to 1.5¢ per Mcf. In turn, the amount of these adjustments will be reduced by price increases for high Btu content, and by revenue from plant liquids.[92] We believe that, in the circumstances presented, these estimates were adequate. The Commission's information about existing contracts was evidently not sufficiently complete to permit precise calculations from previous experience. Moreover, since the adjustments are to be, in the first instance, the product of agreement between the parties,

[92] The Commission pointed out that sellers of gas-well gas receive payments for "liquid hydrocarbons extracted from the gas by the pipelines." 34 F. P. C., at 1073. These payments may amount to 0.6 to 0.8¢ per Mcf in the Permian Basis. *Ibid.* An allowance of only 0.2¢ per Mcf was incorporated by stipulation in the new gas-well gas rate. *Id.*, at 388. Moreover, producers receive "substantial payments" for liquids extracted from oil-well gas sold under Spraberry contracts. *Ibid.* And see n. 111, *infra*. Compare 34 F. P. C., at 208–209.

a dimension of uncertainty is necessarily created. Depite these difficulties, the Commission provided reasonably specific estimates of the range of adjustments that it believed would result. We are entitled now to take notice that these are confirmed by subsequent events.[93] We hold that the Commission's promulgation of quality standards was accompanied by adequate findings as to their revenue consequences.

The Commission did not provide specific findings as to the effect of these revenue adjustments upon the producers' rate of return. This was an unfortunate omission, but it does not preclude evaluation of the Commission's conclusions. It would appear, and counsel for the Commission have estimated, that the rate of return "on average quality" natural gas sold in the Permian Basin might, after quality adjustments, yield "as little" as 10 to 12% on equity.[94] These figures presumably must be adjusted upward for sales of pipeline quality gas, sales of gas with a high Btu content, and revenue from plant liquids. Even as adjusted, however, the aggregate return permitted to producers will apparently exceed only slightly that customarily allowed pipelines, for the quantities of pipeline quality and high Btu content gas produced in the Permian Basin are evidently quite small. Nevertheless, the record before the Commission contained evidence sufficient to establish that these rates, as adjusted, will maintain the industry's credit and continue to attract capital. Although the Commission's position might at several places usefully

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[93] The Commission's order accepting quality statements filed by producers in the Permian Basin indicates that the adjustments average 0.78¢ per Mcf for old gas-well gas, and 0.86 per Mcf for old residue gas. 37 F. P. C. 52, 53.

[94] Brief for the Federal Power Commission 141.

be clarified,[95] the producers have not satisfied the "heavy burden" placed upon those who would set aside its decisions.[96]

V.

We have concluded that the various segments of the Commission's rate structure do not separately exceed or abuse its authority. Nonetheless, certain of the producers have argued vigorously that the aggregate revenue permitted by the rate structure is, or might be, inadequate. They urge that the imposition of maximum prices computed from composite costs reduces contract prices to a maximum premised on a cost average; and they conclude that the Commission has therefore denied them the revenue necessary for appropriate programs of exploration and development. Related questions troubled the Court of Appeals. It held that the Commission must, under *Hope*, place in balance revenue and requirements, and that findings must be provided that will permit reviewing courts to assess the skill with which the Commission has employed its scales. Although we sustain, for reasons stated above, the Commission's rate

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[95] The Commission emphasized that because exploration "is fraught with uncertainties foreign to its transmission," a "greater return" should be allowed. 34 F. P. C., at 201. Nonetheless, as we have found, the rate of return actually permitted by the Commission, after allowance for quality and other adjustments, does not substantially exceed that permitted to pipelines. We note, however, that the risks incidental to exploration have not always been thought to be greatly in excess of those incidental to transmission. See Kitch, *supra*, at 201. And see on the insurance principle, Nelson, Percentage Depletion and National Security, reprinted in Federal Tax Policy for Economic Growth and Stability, papers submitted to the Joint Committee on the Economic Report, 84th Cong., 1st Sess., 463, 470. See also Dirlam, Natural Gas: Cost, Conservation, and Pricing, 48 Am. Econ. Rev. 491, 498. And compare 3 Joint Appendix 907.

[96] *Federal Power Commission* v. *Hope Natural Gas Co.*, *supra*, at 602.

structure, we believe it proper to examine these additional contentions.

Three interrelated questions are pertinent. First, the adequacy of the Commission's aggregate revenue findings must be assessed. Second, we must consider the producers' contentions that the Commission has significantly underestimated the deficiences of present programs of exploration. Finally, we must determine whether the Commission's use of averaged costs has created a rate structure that is unjust and unreasonable in its consequences.

We turn initially to the adequacy of the Commission's revenue findings. It must be emphasized that we perceive no imperative obligation upon the Commission, under either the Natural Gas Act or the decisions of this Court, to provide an apparatus of formal findings, in terms of absolute dollar amounts, as to aggregate revenue and aggregate revenue requirements. It is enough if the Commission proffers findings and conclusions sufficiently detailed to permit reasoned evaluation of the purposes and implications of its order. Compare *Chicago & N. W. R. Co.* v. *Atchison, T. & S. F. R. Co.*, 387 U. S. 326, 345–347. As we shall show, the Commission's revenue findings were not, in the circumstances of these proceedings, unduly imprecise. The ambiguities about which the Court of Appeals expressed concern were two. First, the court faulted the Commission for the imprecision of its findings as to the revenue consequences of the quality and Btu adjustments. We have already found adequate the Commission's estimates of the necessary price reductions. Second, the court stated that the rate structure could not be accurately assessed, since the Commission has incorporated in its calculations both cost and noncost factors; it believed that "the Commission's decision rides two horses and we have no way of knowing the outcome of the race." 375 F. 2d, at 34.

We find this unpersuasive. Although the Commission's exposition of these questions might have been more carefully drawn, it has quite appropriately incorporated in its calculations factors other than producers' costs.[97] Cost and noncost factors do not, as the Court of Appeals supposed, race one against the other; they must be, as they are here, harnessed side by side. The Commission's responsibilities necessarily oblige it to give continuing attention to values that may be reflected only imperfectly by producers' costs; a regulatory method that excluded as immaterial all but current or projected costs could not properly serve the consumer interests placed under the Commission's protection. We have already considered each of the points at which the Commission has given weight to noncost factors, and have found its judgments consistent with the terms and purposes of its statutory authority.[98] There is no reason now to

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[97] The Commission first emphasized that "we make clear that we do not confine ourselves to a cost calculation in determining just and reasonable rates." 34 F. P. C., at 190. It later said that "there is no justification in this area for any adjustment of a cost-determined ceiling price." It added that "no such [noncost] adjustments are required in the Permian Basin." *Id.*, at 207. Yet it is quite plain that the Commission's rate structure is, and was intended to be, significantly influenced by "non-cost considerations." Unfortunately, the Commission never paused to reconcile these general observations with the specific terms of its rate structure.

[98] We understand the principal points at which the Commission employed noncost factors to be four. It used the logic of functional pricing to justify both its two-price rate structure and its selections of sources of cost data. Second, it explained its imposition of a single maximum rate upon all old gas by, among other reasons, the importance of a relatively uncomplicated rate structure. Third, the Commission justified its adoption of a temporary period of price restriction by the exigencies of area regulation. Fourth, the Commission based its calculation of the rate of return upon risk factors that it did not directly reduce to cost components.

return these cases to the Commission for clarification of these issues."[99]

Nor can we hold that the Commission has underestimated the deficiencies of current programs of exploration. The producers' argument has been uniformly premised upon the assertion that the ratio of proved recoverable reserves to current production is an accurate index of the industry's financial requirements. The producers urge that this ratio has dangerously declined,[100] and conclude that any reduction of prevailing field prices will jeopardize essential programs of exploration. There is, however, substantial evidence that additions to reserves have not been unsatisfactorily low,[101] and that

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[99] We are cognizant, as presumably is the Commission, of the forceful argument that the computation of rates from costs is ultimately circular. See Kitch, *supra*, at 195–196; compare Kahn, *supra*, at 510–514. See also Eckstein, *supra*, at 129–131. The Commission has not, however, relied simply upon cost computations, and we have found no basis on which we could now properly set aside the Commission's orders. We assume that the Commission will continue to examine both the premises of its regulatory methods and the consequences for the industry's future of its rate-making orders. Nothing under the Act or the cases of this Court compels the Commission to reduce its regulatory functions to self-fulfilling prophecies. Compare *Federal Power Commission* v. *City of Detroit*, 230 F. 2d 810, 818.

[100] The ratio "has been as high as 32.5 to 1 in 1946 and it has steadily declined to about 18.7 to 1 in 1963 . . . ." 34 F. P. C., at 183. At year end of 1965, proved recoverable reserves totaled 286.5 trillion cubic feet; withdrawals in 1965 were 16.25 trillion cubic feet. American Gas Association, 1966 Gas Facts 1 (1966). These questions may be traced in testimony at 1 Joint Appendix 20–34, 76–95, 97–111, 352–360; 2 *id.*, at 459–471. See also Hooley, *supra*, 5–25.

[101] In 1965, "[g]ross additions to reserves aggregated 21.3 trillion cubic feet, the third highest since the Natural Gas Reserves Committee initiated its reports in 1946." American Gas Association, *supra*, at 5. Further, "[o]ver the past twenty years, gross addi-

recent variations in the ratio of reserves to production are of quite limited significance.[102] Nothing in the record establishes as proper or even minimal any particular ratio.[103] We do not suggest, nor did the Commission,[104] that the Commission should not continuously assess the level and success of exploration, or that the relationship between reserves and production is not a useful benchmark of the industry's future. We hold only that the Commission here permissibly discounted the producers'

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tions have resulted in more than 343 trillion cubic feet being added to the nation's proved reserves of natural gas. During this same period, net production of natural gas totaled 207 trillion cubic feet. *Ibid.* See for similar evidence, American Gas Association, 1967 Gas Facts 5 (1967). It is, however, proper to recognize that the ratio of new discoveries to annual net production has generally declined since 1946, although the decline is neither steep nor consistent. See 34 F. P. C., at 319; 1 Joint Appendix 76–95, 97–111. And see generally Cram, Introduction to the Problem of Developing Adequate Supplies of Natural Gas, Southwestern Legal Foundation, Economics of the Gas Industry 1 (1962).

[102] It is pertinent that the American Gas Association in 1957 observed of the reserves-to-production ratio that so "long as new additions exceed production there need be little cause for concern about such an hypothetical ratio." 1957 Gas Facts 6 (1957). See for similar evidence 34 F. P. C., at 309–317.

[103] The producers have argued vigorously that 20 to 1 is the minimum reserves-to-production ratio. There is, however, ample evidence to support the Commission's judgment that lower ratios are permissible. One intervenor witness forcefully described the concern for that ratio as a "neurotic preoccupation." 1 Joint Appendix 357. See also *id.*, at 352–360; and 2 *id.*, at 459–471. These questions are usefully discussed in Terry, Future Life of the Natural Gas Industry, Southwestern Legal Foundation, *supra*, at 275, 284–285; and in Netschert, Economic Aspects of Natural Gas Supply, *id.*, at 27, 56–68.

[104] Indeed, the Commission described the adequacy of reserves as "an important factor in our determination here," and said that it will "continue to be an important factor in reviewing area rates in the future . . . ." 34 F. P. C., at 185.

reliance upon this relationship to establish the inadequacy of its rate structure.

Finally, we turn to the contention that these area maximum rates were derived from averaged costs, and therefore cannot, without further adjustment, provide aggregate revenue equal to the producers' aggregate requirements. The producers that support the judgments below emphasize that revenue in 1960 from all jurisdictional sales in the Permian Basin averaged 12.72¢ per Mcf.[105] They contend that this revenue will, under the Commission's order, be reduced by the amount of any necessary quality deductions, by refunds, and by loss of revenue from abrogation of contract prices above the area maximum rates. The producers conclude that the Commission's rate structure will necessarily cause revenue deficiencies, measured by the difference between actual average revenue (12.72¢ less these adjustments) and 14.5¢ per Mcf, the rate assertedly found by the Commission to be just and reasonable for flowing gas. They urge that the Commission was properly obliged to balance revenue and costs either by increasing the area minimum rate, or by placing the area maximum rates above average costs.

The inadequacies of this reasoning are several. First, it neglects important characteristics of the rate structure. We understand the Commission, despite certain infelicities of its opinion,[106] to hold that the just and reasonable rate for old gas not of pipeline quality is 14.5¢ per Mcf,

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[105] There appears to be some uncertainty about the appropriate figures. Compare Brief for the Federal Power Commission 96. The producers' use of 12.72¢ per Mcf is supported by 7 Joint Appendix 538e.

[106] Certain of the producers urge that the Commission described 14.5¢ and 16.5¢, unadjusted for quality deficiencies, as the just and reasonable rates for the Permian Basin. This ellipsis may sometimes have entered the Commission's opinion, but on fair reading its intentions seem entirely clear. See 34 F. P. C., at 239.

less the cost of processing necessary to raise it to pipeline quality. The Commission's net just and reasonable rate for such gas is therefore 13.0¢ to 13.8¢, and not 14.5¢ per Mcf.[107] Further, average unit revenue will not be simultaneously reduced, as the producers have suggested, by refunds and by abrogation of above-ceiling field prices. As to the past, the two are in large part synonymous; as to the future, only the latter will be applicable.

Moreover, the Commission's computation of its area rates was not intended to reflect with complete fidelity either the producers' average costs or their sources of revenue. First, the actual average unit costs of casinghead and residue gas are substantially lower than the average unit costs of flowing gas-well gas;[108] yet the maximum rate for all associated and flowing gas was derived entirely from the latter. It follows that the producers' net revenues from sales of casinghead and residue gas will prove higher than the return formally permitted by the Commission. Second, producers receive significant payments for liquid hydrocarbons extracted by the pipelines during their processing of gas-well gas.[109] The maximum rate for new gas-well gas

[107] It is pertinent to reiterate that the Commission has recently calculated the actual adjustments required by the quality statements filed by producers in the Permian Basin through August 31, 1966, as 0.78¢ per Mcf for old gas-well gas and 0.86¢ per Mcf for old residue gas. *Area Rate Proceeding (Permian Basin Area)*, 37 F. P. C. 52, 53.

[108] The Commission stated that "the evidence in the record makes clear that with respect to casinghead gas and residue gas derived therefrom (which together make up by far the largest share of the Permian gas subject to quality adjustments) the costs are substantially below the 14.5 cents per Mcf ceiling price." 34 F. P. C., at 1072. And see *id.*, at 356–360.

[109] The Commission pointed out that there was evidence that suggested that these payments average 0.6¢ to 0.8¢ per Mcf for gas-well gas in the Permian Basin. 34 F. P. C., at 1073.

evidently takes into account only part of these receipts, and that for old gas-well gas disregards altogether this source of additional revenue.[110] Third, some 20% of all the gas sold under the Commission's jurisdiction in the Permian Basin is controlled by Spraberry contracts, by which producers are paid for liquids processed by the pipelines from oil-well gas.[111] Much of the gas sold at prices below the applicable area maximum rate is governed by such contracts.[112] This source of revenue was not incorporated in the Commission's calculation of the maximum rate for oil-well gas. The Commission was unable to compute with precision the revenue obtained by producers from these disparate sources, but it estimated it to be "substantial." 34 F. P. C., at 1073.

Finally, the producers have ignored the limits of the Commission's statutory authority. This Court has held, under the Federal Power Act, that the Commission may not abrogate existing contractual arrangements unless the contract price is so "low as to adversely affect the public interest—as where it might impair the financial ability of the public utility to continue its

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[110] The new gas-well gas rate includes a credit of 0.2¢ per Mcf for plant liquids: 34 F. P. C., at 197, 1073. This figure was determined by stipulation. *Id.*, at 388. No such credit was included in the flowing gas rate.

[111] The Spraberry, or El Paso, contract is one which provides "for the purchase of casinghead gas by a pipeline which processes the gas, pays the producer a percentage of the proceeds from the sale of the extracted liquids, plus a fixed price for the residue gas delivered to the pipeline." 34 F. P. C., at 208. The presiding examiner would have essentially prohibited such contracts in the Permian Basin, but the Commission declined to do so. Nonetheless, it asserted jurisdiction, we think properly, over the sale of casinghead gas under the contract. The Commission indicated that the producers' revenue from the contracts for the extracted liquids is "substantial." 34 F. P. C., at 1073.

[112] Compare 34 F. P. C., at 209 and 1072.

service, cast upon other consumers an excessive burden, or be unduly discriminatory." *Federal Power Commission* v. *Sierra Pacific Power Co., supra,* at 355. It is not enough, the Court there held, that the contract price permits less than a fair return; the Commission may not, absent evidence of injury to the public interest, relieve a regulated company of "its improvident bargain." *Ibid.* The pertinent provisions of the Federal Power Act "are in all material respects substantially identical to the equivalent provisions of the Natural Gas Act." *Id.,* at 353. It follows that the Commission was here without authority to abrogate existing contract prices unless it first concluded that they "adversely affect the public interest." And see *Federal Power Commission* v. *Tennessee Gas Co.,* 371 U. S. 145, 153. The Commission found that field prices of less than 9¢ per Mcf had such consequences, but it declined so to hold for all prices less than the two area maximum rates.[113] There was no evidence before the Commission that required a different result, or that would now permit this Court to set aside the Commission's judgment.

It does not, however, necessarily follow that the Commission was forbidden to consider, as it selected maxi-

[113] The Commission's calculation of the minimum rate was, however, left largely unexplained. The Commission clearly found that "the establishment of minimum rates in this case is in the public interest and that the price impact on the consumer will be *de minimis.*" 34 F. P. C., at 231. It failed to offer any explanation of its selection of 9¢ as the minimum rate, relying entirely on the examiner's preference for that figure. The examiner adopted two minimum rates: 9¢ per Mcf for residue and gas-well gas, and 7¢ per Mcf for casinghead gas. His calculations were evidently premised on his computation of the revenue standard for the various classes of natural gas. See *id.,* at 369. The composite explanation for the choice of 9¢ as the area minimum rate is thus imprecise. Nonetheless, the Commission reasonably concluded that a minimum rate was imperative, and there is no evidence before us that permits the conclusion that its selection was unjust or unreasonable.

mum rates from within the zone of reasonableness, the aggregate revenue deficiencies that might result from improvident contractual limitations. Within this zone, the Commission is permitted to give weight to the consequences upon producers, and thereby upon supply, of such limitations. Nonetheless, the Commission permissibly declined to make adjustments in the area rates because of prevailing contract prices. It recognized that such adjustments would increase the cost of natural gas to some groups of consumers, in order simply to offset bargains previously obtained by others.

The regulatory system created by the Act is premised on contractual agreements voluntarily devised by the regulated companies; it contemplates abrogation of these agreements only in circumstances of unequivocal public necessity. See *United Gas Co.* v. *Mobile Gas Co., supra.* There was here no evidence of financial or other difficulties that required the Commission to relieve the producers, even obliquely, from the burdens of their contractual obligations. We do not suggest that the Commission need not continuously evaluate the revenue and other consequences of its area rate structures. A principal advantage of area regulation is that it centers attention upon the industry's aggregate problems, and we may expect that, as the Commission's experience with area regulation lengthens, it will treat these important questions more precisely and efficaciously. We hold only that, in the circumstances here presented, the Commission's rate structure has not been shown to deny producers revenues consonant with just and reasonable rates.[114]

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[114] Two additional issues should properly be separately considered. First, the States of Texas and New Mexico have urged that we reconsid r *Hope,* and require the Commission to give special weight to the probable effects of its orders on the economies of producing States. We have examined these contentions, but decline to modify

VI.

There remain for consideration various additional objections by the producers to the Commission's cost determinations, and to the sources of information from which those determinations were derived. These questions were not decided by the Court of Appeals. Although this Court ordinarily does not review an administrative record in the first instance, *United States* v. *Great North-*

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the treatment of the similar questions in *Hope*. See 320 U. S., at 607–614. As we said there, we do not "suggest that Congress was unmindful of the interests of the producing states . . . when it drafted the Natural Gas Act." *Id.*, at 612. But to go as far as Texas and New Mexico now ask "raises questions of policy which go beyond our province." *Id.*, at 614.

Second, the Commission indicated that it would apply these area rates to sales initiated during the pendency of these proceedings. 34 F. P. C., at 237. See order issuing certificates, *id.*, at 418. The effect of this order is to impose these rates as the in-line rate for the Permian Basin for periods prior to the Commission's decision in these proceedings. See generally *United Gas* v. *Callery Properties*, *supra*, at 226–228. The Court of Appeals found it unnecessary to decide the propriety of this arrangement. 375 F. 2d, at 35–36. Nonetheless, we believe that in the circumstances here presented it is appropriate to resolve this issue without awaiting consideration by that court. Compare *Chicago & N. W. R. Co.* v. *Atchison, T. & S. F. R. Co.*, 387 U. S. 326, 355–356. We hold that the Commission was not forbidden to employ the area rates as the in-line rate for purposes of sales initiated after commencement of its proceedings, but before its final decision. The area rates were properly calculated as the just and reasonable rates for the Permian Basin for periods subsequent to the periods at issue, on the basis of cost factors believed to be stable throughout these periods. As the Commission observed, to prevent their use as the in-line rate "would require an unending succession of Section 5 area rate proceedings, each covering only the sales instituted prior to the institution of the proceeding." 34 F. P. C., at 237. We need not, however, determine for what further periods or in what other circumstances the Commission may use unadjusted area rates as in-line rates. Orders involving § 7 proceedings commenced after the Commission's decision in these proceedings were not before the Commission, and are not now before the Court.

ern R. Co., 343 U. S. 562, 578; *Seaboard Air Line R. Co.* v. *United States*, 382 U. S. 154, 157; there are persuasive reasons now to reach and decide these remaining issues. Almost eight years have elapsed since the Commission commenced these proceedings; we are convinced that producers' rates may be fairly and effectively regulated only after this and the other area proceedings now before the Commission have been successfully terminated. These issues were briefed and argued at length before this Court; very extended additional proceedings would doubtless be necessary in order to review them yet again.

Moreover, the circumstances here parallel closely those in *Chicago & N. W. R. Co.* v. *Atchison, T. & S. F. R. Co.*, 387 U. S. 326. It was there said that the "presentation and discussion of evidence on cost issues constituted a dominant part of the lengthy administrative hearings, and the issues were thoroughly explored and contested before the Commission. Its factual findings and treatment of accounting problems concerned matters relating entirely to the special and complex peculiarities of the railroad industry. Our previous description of the Commission's disposition of these matters is sufficient to show that its conclusions had reasoned foundation and were within the area of its expert judgment." *Id.*, at 356. This reasoning is entirely applicable to the circumstances presented here; we hold, as did the Court there, that no useful purpose would be served by further proceedings in the Court of Appeals, and that there is no legal infirmity in the Commission's findings.[115]

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[115] It is, however, proper to take special notice of various arguments that have been vigorously pressed by certain of the producers. First, it is urged that the Commission should have included an allowance for federal income taxes in the rate for new gas-well gas. It appears that the producers originally presented no evidence supporting such an allowance, and that producer witnesses did not include such costs in their computations. Further, there was evi-

VII.

Lastly, we reach questions of the validity of the refund obligations imposed by the Commission's orders. Two categories of refunds were created. First, producers must return amounts charged in excess of the applicable area rates, including quality and Btu adjustments, for periods following September 1, 1965, the date of effectiveness of the Commission's order. 34 F. P. C., at 243. The Commission imposed interest of 7% upon these refunds.[116] Second, producers must refund amounts collected in excess of the applicable area rates, including quality and Btu adjustments, during previous periods in which their prices were subject

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dence that the computation of such an allowance would be difficult, see 3 Joint Appendix 992, and that, in any event, the producers will incur "no Federal income tax liability at any return up to 15 percent." 34 F. P. C., at 206. In these circumstances, we think that the Commission did not err in excluding such an allowance.

Second, it is urged that the Commission failed to include an adequate allowance for exploration costs. We must emphasize that we perceive no obligation upon the Commission, under the Constitution or the Natural Gas Act, to permit recovery of all exploration costs, regardless of their amount and prudence. Although other methods of computing these costs might have been used by the Commission, see *id.*, at 192–193, we have found nothing that would properly permit reversal of the Commission's judgment.

Finally, Sun Oil asserts that it was at various points denied due process. It is enough to say that we have examined these contentions, and find them without substance.

[116] We note that the terms of the stay entered by the Court of Appeals on January 20, 1966, would reduce this rate of interest to 4½%. See 12 Transcript of Record 12, 13–14. The court offered no explanation of this modification of the Commission's orders. We perceive no basis for the court's order, particularly since the question was evidently not raised in the producers' applications to the Commission for rehearing. See § 19 (b); 15 U. S. C. § 717r. And see *Wisconsin* v. *Federal Power Commission*, *supra*, at 307. We hold that the Commission's order imposing interest of 7% must be restored.

to refund under § 4 (e). Such obligations ultimately arise from filings by the producers under § 4 (d) for increases in existing price schedules. The appropriate interest on these refunds was held to be that specified in each § 4 (e) proceeding.[117] Refunds in both categories were, under the Commission's order, to be measured by comparison of individual company price schedules with the applicable area rates.

The Court of Appeals initially sustained the Commission's refund orders. 375 F. 2d, at 33. On petitions for rehearing, however, the court held that "no refund obligation may be imposed for a period in which there is a group revenue deficiency." *Id.*, at 36. The court believed this to be an essential corollary of the Commission's asserted obligation to bring into balance group costs and group revenues; it would have permitted the Commission to order refunds only in periods in which aggregate revenue is found to exceed aggregate revenue requirements, and only as to the amount of the excess. The Commission was expected to apportion any refunds "on some equitable contract-by-contract basis." *Ibid.*

We find the court's reasoning unpersuasive. The Commission may, in the course of its examination of the producers' financial positions, consider the possible refund consequences of its rate-making orders; but its power to order refunds is not limited to situations in which group revenues exceed group revenue requirements. Area regulation offers a more expeditious method for the calculation of just and reasonable rates, and it will necessarily more rigorously focus the Commission's attention upon the producers' common problems. It does not, however, lessen the significance, or modify the incidents, of findings that specific rate levels are or are

[117] We understand these interest rates to be in some cases 6% and in others 7%. Brief for the Federal Power Commission 169.

not just and reasonable within the meaning of §§ 4 (a) and 5 (a). A rate found to be unjust and unreasonable is declared by § 4 (a) to be unlawful; if the rate has been the subject of a rate schedule modification under § 4 (d), the Commission is empowered by § 4 (e) to order its refund. We can see no warrant, either in the Act or in the terms of the Commission's orders, now to impose any additional limitations upon the Commission's authority; we hold that the Commission's discretion is not constricted in the fashion described by the Court of Appeals.

Wisconsin v. *Federal Power Commission, supra,* does not require differently. It did not, as the Court of Appeals evidently supposed, create any imperative procedure for the disposition of refunds from locked-in rates.[118] The Commission there held that, given its decision to begin a system of area regulation, it was not in the public interest "to reopen these proceedings, to determine a cost of service on the basis of completely new evidence and to attempt to determine rates on the basis of Phillips' individual costs of service." 24 F. P. C., at 1009. No just and reasonable rates had been, or could then have been, calculated for Phillips' sales in the relevant periods. The Commission did not urge,[119] and this Court did not hold, that Phillips' revenue deficiencies imposed a limitation upon the Commission's authority to require refunds; the Court merely sustained the Commission's refusal, in the circumstances there presented, to pursue further a lengthy and burdensome

[118] A locked-in rate is one in which an "increased rate is later superseded by a further increase . . . ." It is thus "effective only for the limited intervening period, called the 'locked-in' period, and retains significance in § 4 (e) proceedings only in respect of its refundability if found unlawful." *Wisconsin* v. *Federal Power Commission, supra,* at 298, n. 5.

[119] See Brief for the Federal Power Commission in Nos. 72, 73, 74, October Term, 1962, at 48–53.

series of § 4 (e) proceedings. See also *Hunt Oil Co.*, 28 F. P. C. 623; and *Wisconsin* v. *Federal Power Commission, supra,* at 306, n. 15.

The Commission reasonably concluded that the adoption of a system of refunds conditioned on findings as to aggregate area revenues would prove both inequitable to consumers and difficult to administer effectively. Such arrangements would require consumers to accede to unjust and unreasonable prices merely because other prices, perhaps ultimately benefiting other consumers, had proved improvident. Nor would these arrangements necessarily serve the interests of the improvident producers; they might merely permit more prudent competitors to escape refunds on concededly unlawful prices.[120] We hold that the Commission's refund orders do not exceed or abuse its statutory authority.[121]

The motions for leave to adduce additional evidence are denied, the judgments of the Court of Appeals are affirmed in part and reversed in part, as herein indicated, and the cases are remanded to that court for further proceedings consistent with this opinion.

It is so ordered.

MR. JUSTICE MARSHALL took no part in the consideration or decision of these cases.

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[120] Compare *Federal Power Commission* v. *Tennessee Gas Co.*, 371 U. S. 145, 152–153.

[121] We note that Mobil and others have argued vigorously that the Commission's refund formulae would impose obligations to refund amounts below the "last clean rate." The latter is a rate established by a final permanent certificate unconditioned by a refund obligation under either § 7 or § 4 (e). The Commission concluded that it need not reach this question since "no such situation has been presented as resulting from our order herein." 34 F. P. C. 1074–1075. And see *Gulf Oil Corp.*, 35 F. P. C. 375. Given the Commission's postponement of the question, we intimate no views on the proper limitations of the Commission's authority in this regard.

SUPREME COURT OF THE UNITED STATES

Nos. 90, 95, 98, 99–102, 105, 117, 181, 261, 262, 266, 388.—OCTOBER TERM, 1967.

Permian Basin Area Rate Cases.	On Writs of Certiorari to the United States Court of Appeals for the Tenth Circuit.

[May 1, 1968.]

MR. JUSTICE DOUGLAS, dissenting.

I.

What the Court does today cannot be reconciled with the construction given the Natural Gas Act by *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U. S. 591, 602. In that case we said, in determining whether a rate had been properly found to be "just and reasonable" under the Act, that

(1) "it is the result reached not the method employed which is controlling";

(2) it is "not theory but the impact of the rate order which counts";

(3) "If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at an end."

The area rate orders challenged here are based on averages.[1] No single producer's actual costs, actual risks, actual returns are known.

[1] In its effort to determine costs of production, the Commission sent out questionnaires (Appendices A, B, and C), to 458 producers in the Permian Basin Area, 361 of whom were named respondents in these proceedings. Appendices B and C inquired as to production costs; Appendix A covered drilling costs. Appendix B was a comprehensive questionnaire designed for major producers, while Appendix C was a simplified form for small producers (those with

The "result reached" as to any producer is not known. The "impact of the rate order" on any producer is not known.

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under 10,000,000 Mcf in nationwide jurisdictional sales in 1960). Small producers, however, could answer either Appendix B or C.

The Commission received complete responses on Appendix B from 67 producers, of which 25 were small producers. Responses to Appendix C were filed by 105 small producers. (Some of the responses represented composite data for more than one company.) The Commission excluded the Appendix C replies from consideration. 34 F. P. C., at 213–214.

The Commission's staff used these responses to develop a composite cost of service study. The staff arranged the Appendix B replies on various charts, arraying the data from high to low in respect to various categories (*e. g.*, total unit costs and allowances, cash expense unit costs). Then, weighted cost averages were computed—*i. e.*, the replies on Appendix B were given a weight proportional to the volume Mcf covered by the responses.

In establishing the rate for new gas-well gas, the Commission elected to proceed by determining costs on a national, rather than an area, basis. 34 F. P. C., at 191. It used the Permian questionnaire responses, however, as "a vital source of information," *ibid.*, employing them in determining various components of the final national average cost. See *id.*, at 191–200. The Commission also turned to various "well-recognized and authoritative industry data sources [which] were utilized by various witnesses in the proceedings." *Id.*, at 191. These included such sources as the United States Census Bureau's Census of Mineral Industries for 1958 (wherever this source was used, the figures were trended to 1960 on the basis of the Permian questionnaire data), the 1961 Chase Manhattan Bank's Annual Analysis of the Petroleum Industry, and the 1958 Joint Association Survey (a survey made by three industry trade groups based on questionnaires mailed to all member companies).

Various adjustments were made because of factors such as atypical years or the Permian questionnaire data being disproportionate to the national figures. See 34 F. P. C., at 194–196.

The Commission's rate for flowing gas was based primarily on the questionnaire data which had been compiled by the staff into a composite cost of service study. The Commission in this instance based the ceiling price on Permian Basin area costs, although it used nationwide data in determining exploration and development

The "total effect" of the rate order on a single producer is not known.

It is said, however, that if any producer is aggrieved, he may apply for relief and if he fails to obtain relief he can resort to the courts. But unless we know the standards which will govern in case he applies for relief, we are, with all respect, mouthing mere words when we say the rate is "just and reasonable." In absence of knowledge, we cannot possibly perform our function of judicial review, limited though it be.

It was urged in the dissent in *Hope* that a system of regulation be authorized which would center not on the producer but on the product "which would be regulated with an eye to average or typical producing conditions in the field." 320 U. S., at 652. But the Court rejected that approach, saying that §§ 4 (a) and 5 (a) of the Natural Gas Act contained "only the conventional standards of rate-making for natural gas companies." *Id.*, at 616.

Group regulation of rates is not, of course, novel. It has at times been authorized. The Civil Aeronautics Act, 49 U. S. C. § 1482 (e), permits it. And see *General Passenger-Fare Investigation*, 32 C. A. B. 291. Under the War Power, extensive price regulation on a group basis was sustained. *Bowles* v. *Willingham*, 321 U. S. 503, 517–519. The Interstate Commerce Commission has undertaken it, as revealed by the *Divisions of Revenue* cases. *New England Divisions Cases*, 261 U. S. 184; *United States* v. *Abilene & Southern R. Co.*, 265 U. S. 274; *Chicago & N. W. R. Co.* v. *Atchison, T. & S. F. R. Co.*, 387 U. S. 326. See also 49 U. S. C. § 15 (3). The requirement in the *Divisions of Revenue* cases is that the

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costs. See 34 F. P. C., at 212–218. And, although the term "flowing gas" was defined to include casinghead gas, residue gas derived therefrom and old gas-well gas, the Commission used only the costs of the old gas-well gas in determining the area rate. *Id.*, at 208–212.

group evidence be "typical in character, and ample in quantity, to justify the finding made in respect to each division of each rate of every carrier." 261 U. S., at 196–197. In other words, where the rates fixed will recover the *typical* group cost of service, the individual's right to a minimum of its operating expenses and capital charges is protected. Cost of service includes operating expenses and capital charges. *Federal Power Commission* v. *Natural Gas Pipeline Co.*, 315 U. S. 575, 607 (concurring opinion). With that protection I can see no reason why group rates may not be sanctioned here. But more is required than the Commission undertook to do in these cases.

In the present cases the Commission found averages; but there are no findings as to the typicality and representative nature of those averages.[2] We certainly cannot

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[2] Nor did the Commission discuss the distribution of the data within the grouping being considered—that is, matters of the concentration, symmetry, and uniformity of the data.

The Commission asserts in this Court that "while producer costs vary widely from year to year on an individual-company basis, in the long run the costs of most producers tend to approximate the industry average." In support of this assertion, it cites record testimony and refers to the existence of fairly stable industry averages for drilling costs of successful wells as compared with erratic figures for individual companies. Apart from the fact that not all of the testimony cited stands for the proposition stated by the Commission, but indicates at most only that there is less instability in individual producers' costs over time rather than that they tend to average out, there was conflicting testimony on the point of representativeness offered by a witness for the Sun Oil Company, who showed that certain averages were not representative of the basic data because the distribution of the data was so widely spread and skewed from the *mean*. The fact that there were no comprehensive cost data suitable for supplying all the necessary elements of a cost study (see 34 F. P. C., at 191) does not excuse the Commission from finding whether the data it chose to use were *typical and representative*. In fact, the necessity of making such a finding is accentuated, because of the number of

take judicial notice that the averages are typical. Mr. Justice Brandeis in the leading *Divisions of Revenue* case said that "averages are apt to be misleading" and they

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different sources entering into the computation of virtually all of the individual cost components. See 34 F. P. C., at 191–207, 212–218.

The Commission stated that it would use national rather than area data in arriving at a cost for new gas-well gas, noting: "It may well be that in some areas production costs may vary sufficiently from the national average to warrant a different treatment but on the record in this case we agree that cost of new gas well gas should be determined on the basis of nationwide data." 34 F. P. C., at 191. Since the Commission was discussing the use of *area* versus *national* costs, that statement at most suggests only that the Permian Basin composite costs did not vary sufficiently from the national average costs to warrant not using the latter, rather than that the Commission was comparing the national average with *individual* producer costs in the Permian Basin.

Perhaps for a group as large and diversified as that involved in this case, typical and representative averages cannot be computed. Hunt Oil Company presses this point strongly, contending that wide variations in unit costs are an inherent characteristic of gas and that a uniform ceiling rate fixed at the average composite cost level is unlawful *per se* because of the wide disparity in costs among different categories of gas as well as among different producers. The Commission itself noted this fact of wide variation in individual costs as part of its justification for basing costs on overall producer experience (see 34 F. P. C., at 179); but, as pointed out, it failed to go forward and determine whether the averages used to construct this overall producer experience were typical and representative. If they were not, then perhaps the Commission could have subdivided the group until it arrived at groupings whose members possessed essentially similar characteristics. Cf. *United States* v. *Borden Co.*, 370 U. S. 460, 469. This would not mean that the Commission would in effect be returning to an individual producer regulatory method; rather, the Commission could stop the subdivision at that point where group averages became typical and representative. But, as this case now stands, the Commission has not made the necessary findings; and, of course, this Court, lacking the required expertise, cannot undertake to supply those findings for the Commission, nor is it our function to do so. See, *e. g.*, *United States* v. *Abilene & Southern R. Co.*, 265 U. S. 274.

cannot be accepted "as a substitute for typical evidence." 265 U. S., at 291. Cf. *American Motors Corp. et al.* v. *FTC*, 384 F. 2d 247, 251–259, 260–262 (C. A. 6th Cir. 1967).

The Commission found no *median*. Moreover, as we observed in another context, it did not find what were "the average costs" of groups made up of individual members who have "a close resemblance" when it comes to the "essential point or points which determine the costs considered." *United States* v. *Borden Co.*, 370 U. S. 460, 469.

With respect to the cost of new gas-well gas, the Commission did not determine whether the average costs compiled from the questionnaires or derived from industry-wide data were typical or representative.

In finding the cost of flowing gas, the Commission noted that the 1960 level of costs compiled by the staff in large part from the questionnaire responses was "fairly representative of the costs during the three year period ending in 1960" (34 F. P. C., at 213) and that "the 1960 test year is . . . typical of current and future costs of the flowing gas . . . ." *Ibid.* This reference to "representative" and "typical" costs, however, dealt only with *the question of time—i. e.*, the staff's use of 1960 data in developing its composite cost presentation was deemed permissible since 1960 was found to be *a typical and representative year*.

The Court professes to find that the Commission adequately determined that the averages it employed were "typical and representative." *Ante*, at —, —, n. 79. But the statements plucked from the Commission's opinion do not support that interpretation.

The Commission also observed, with respect to the questionnaire data, that 42 of the major producers (representing all but one of the major producers in the

Permian area) responded on the Appendix B questionnaires. The Commission agreed with the Examiner that "the data provided by the major producers with respect to their Permian production was fully representative of the area costs," and that exclusion of the Appendix C returns from small producers would have only a *de minimis* effect. 34 F. P. C., at 214. But although the *data* submitted by the major producers were found to be typical *data for the area,* and I assume also for the major producers in the area, there are no findings whether the *averages* compiled from the data were *typical or representative of the costs* of those major producers or of other producers in the area.

The Commission's statement that the sources used "in combination provide an adequate basis for the costs we have found" certainly cannot be read as a finding that those sources were "typical and representative." Nor does the fact that the sources were "recognized, published statistical data sources," or "well-recognized and authoritative," mean they also contained typical and representative averages.

An average cost is not only apt to be "misleading"; it may indeed not be representative of any producer.

The Commission allowed a 12% rate of return, the return being "on capital invested in finding new gas well gas." 34 F. P. C. 306, 343. "Production investment costs" constituted this "capital invested" and were the bases to which the Commission applied the 12% rate to arrive at a return of 5.21¢ per Mcf to be included in the rate base for new gas-well gas. 34 F. P. C., at 197, 204. These "production investment costs" included successful well costs, lease acquisition costs, and the cost of other production facilities. But they were likewise determined on the basis of *averages.* See 34 F. P. C., at 197–198, 295, 377–382.

The average per capita income of Kuwait is said to be $1,800 a year. But since one man—or family—gets most of the money, $1,800 a year describes only a mythical resident of that country.

The 12% return allowed by the Commission and computed on an average cost basis may likewise have no relation whatever to the reality of the actual costs of any producer.

One producer's cost, though varying from year to year, may average out at $1 per Mcf. Another's may average out at 5¢ per Mcf. Does that make 52.5¢ per Mcf representative of either producer or typical of all producers, or, indeed, typical of any producer, even if the 52.5¢ per Mcf is stable over the entire period of years?

The Commission could follow the lead of the Interstate Commerce Commission and produce rates on a group basis. But it simply has not done so in any rational way.

Averages are apt to take us with Alice into Wonderland. That is one reason why the case should be remanded to the Commission for further findings.

The Commission will allow individual application for relief from these new rates. But it has not prescribed the terms and conditions on which relief will be granted. It has said, however, that an individual must show more than that his cost of service is greater than the averages on which the rate is based. 34 F. P. C., at 180.

In a regulated industry there is no constitutional guarantee that even the most inefficient will survive. *Hegeman Farms Corp.* v. *Baldwin*, 293 U. S. 163, 170–171.

That assumes, however, an ability to withdraw from the business. But a producer of natural gas, may not abandon his existing facilities that supply the interstate market without Commission approval. *United Gas Pipe Line Co.* v. *Federal Power Commission*, 385 U. S. 83.

The Commission says that a producer will be able to obtain relief to cover his out-of-pocket expenses. 34 F. P. C., at 226. Do they include return, depreciation, depletion, exploration, development, and overhead? The Court of Appeals did not know (375 F. 2d, at 30); and we certainly do not. The remand by the Court of Appeals for further definition was therefore clearly necessary. For even if we need not know the precise impact of the new group rate on each producer at the time of the group rate order, we certainly must know the conditions on which a producer can get relief before we can say that a rate as to him is "just and reasonable."

Although we assume that the Act authorizes group rate-making, we cannot disregard the basic structure of the Act, patterned on the "conventional standards of rate-making" (*Federal Power Commission* v. *Hope Gas Co., supra,* at 616) and providing in §§ 4 (a) and 5 (a) that all rates of *"any"* natural gas company be "just and reasonable." Beyond the group is the single producer; beyond the community of producers is the individual. The ultimate thrust of the Act reaches the individual producer; and unless we know what the group rate in final analysis does to him or disables him from doing we cannot perform our duty of judicial review.

II.

If we move to the regulation of the group as such and consider the impact of these rate orders on it, we are likewise not able on the present record to perform our function of judicial review.

It is impossible to say whether the proper revenue requirements of the group can be satisfied under this rate order. For the costs represent averages; and there is no way for us to find from the record whether these averages are typical and what the impact of the rates on the group will be.

The error is compounded when the costs used are the purported costs of gas-well gas and do not include the costs of casinghead gas, residue gas derived therefrom, and gas-well gas from combination leases. The Commission concluded that the costs of casinghead gas and residue gas produced therefrom did not exceed the costs for gas-well gas. Yet at the same time it rejected proffered evidence of higher costs of processing gas to remove liquid hydrocarbons. Commission expertise should not be allowed to make its own "facts" to justify the desired result.

Beyond that are the quality adjustments. Upward price adjustments are permitted for Btu content above 1,050 per cubic foot and downward adjustment for Btu content below 1,000. The Commission was concerned with the value of the "energy content of the gas, which in reality is what the consumer is purchasing." 34 F. P. C., at 223.

With that standard in mind it allowed price reductions

(1) where the gas contains more than 10 grains of hydrogen sulphide or 200 grains of total sulphur per Mcf;

(2) where it contains more than .009 pound per Mcf of water;

(3) when it contains more than 3% by volume of carbon dioxide;

(4) where the gas pressure is less than 500 pounds per square inch.

When any of these standards are not met, the applicable ceiling price is adjusted downward by the net cost of processing the gas to bring it up to standard.

Under the Commission's standards about 90% of the flowing gas moving interstate from the Permian Basin is not of the pipeline quality that the Commission has prescribed. 375 F. 2d, at 30. What the costs will be to convert the gas to these new standards is not found in

this record. Perhaps this deficiency is due to the fact that the Commission, almost as an afterthought and not with clear, advance notice, decided to deal with detailed quality standards. But without knowing these costs through competent evidence, neither we nor the Commission has any way even to guess at whether the new rates will satisfy the criteria of *Hope*.

III.

The Court approves the Commission's treatment of the quality adjustments as a risk of production. But whether they be labeled a risk of production or a cost would seem to be irrelevant. That is a matter of semantics as far as the standards of *Hope* are concerned. For the question is whether we can reasonably determine the end result from the computations of the Commission, including both risk and cost factors.

Any unknown cost is a risk. But the Commission should not be permitted to excuse its failure to solicit or proffer appropriate evidence concerning the cost of converting gas into pipeline quality by labeling that cost a "risk." The Court of Appeals recognized this point. See 375 F. 2d, at 31–32, 35. Commissioner O'Connor noted in his opinion concurring in the denial of rehearing that: "To bury the quality impact in our rate of return determination is to overlook the basis for the 12 per cent allowance: comparable return on equity of 10–12 per cent by the far less risky operations of transmission companies." 34 F. P. C., at 1081. And, as one commentator recently observed:

> "The Commission stated that the rate of return also reflected the risk of finding gas of less than pipeline quality—a clever way of avoiding the quality discount problem. Since there was no evidence in the record as to what those discounts would be, one can only say that 'risks' were involved. It

> is a novel doctrine, indeed, that the rate of return should be adjusted to reflect the risk that the regulatory cost computations are incorrect." [3]

The Court concedes that the lack of specific findings concerning the effect of the quality adjustments upon the rate of return was "an unfortunate omission." *Ante*, at —. But it proceeds to scratch about for evidence to support the Commission. With all respect, there is no competent evidence in the record to permit a meaningful determination of the impact of the quality deductions.[4] The Court of Appeals was clearly correct in

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[3] E. Kitch, The Permian Basin Area Rate Cases and the Regulatory Determination of Price, 116 U. Pa. L. Rev. 191, 201 (1967) (footnote omitted).

[4] Counsel for the Commission observe in their brief to this Court that "no more precise determination was possible in the state of the record" than the 0.7¢ to 1.5¢ range for the average adjustment for quality predicted by the Commission in its opinion denying rehearing. See 34 F. P. C., at 1073. Counsel also cite to certain record testimony and exhibits to support the Commission's determination of this 0.7¢ to 1.5¢ range.

It should be noted first that the 0.7¢ to 1.5¢ prediction is an *average*. I have already discussed the misleading nature of averages not found to be typical and representative, and those observations are equally pertinent here. Moreover, we have no idea whether the Commission relied in making its prediction on any of the sources cited by Commission counsel to this Court.

In computing the 0.7¢ to 1.5¢ range in its opinion denying rehearing, the Commission apparently relied on Commissioner O'Connor's statement in his concurring opinion to the initial decision that the average adjustment would be between 1.0¢ and 1.7¢, and then adjusted those figures to allow for certain changes made with respect to quality standards in the decision denying rehearing. But at the time of the Commission's initial decision, Commissioner O'Connor did not and could not know the costs incurred by the pipelines in bringing gas up to pipeline quality, for the pipelines' processing costs were not in the record. Commissioner O'Connor based his estimate in large part on contract exhibits, as is evident from his opinion; and he noted that a precise adjustment for quality could not be ascertained from those exhibits. See 34 F. P. C.,

remanding to the Commission for proper findings on this point.

Behind the veneer of the Court's opinion may be an unstated premise that the complexity of the task of regulating the wellhead price of gas sold by producers is both so great and so novel that the Commission must be given great leeway. But the permissible bounds, so far as judicial review is concerned, are passed when guesswork is substituted for reasoned findings, when the Commission can avoid finding "costs" by the convenience of calling them "risks," when rates of return are computed for those mythical producers who happen to meet the "average" specifications.

If the task of regulating producer sales within the framework of the Natural Gas Act is as difficult as the present cases illustrate, perhaps the problem should be returned to Congress. But certainly we do little today to advance the cause of responsible administrative action. With all respect, we promote administrative irresponsibility by making an agency's *fiat* an adequate substitute for supported findings.

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at 266. His view of the evidence on this point was clearly stated in his opinion concurring in the denial of rehearing, in which he observed that the record "does not permit a meaningful determination of the impact." 34 F. P. C., at 1081.

Commission counsel also note the Examiner's finding that 1¢ represented a reasonable estimate for bringing new gas-well gas up to pipeline quality and 1¢ to 1.5¢ for old gas-well gas. But, as counsel admit, this finding was not made in conjunction with defining pipeline quality standards on which the costs of conforming the quality of the gas would be based. In fact, the Examiner concluded that: "This record does not permit the determination of a complete set of quality and value differentials." 34 F. P. C., at 370.

The percentage calculations translating the 0.7¢ to 1.5¢ range into terms of rate of return, which are relied upon by the Court, were presented by Commission counsel to this Court and do not appear in the Commission's opinion or in the record.

IV.

New Mexico and Texas, in which the Permian Basin is located, have comprehensive oil and gas conservation codes.[5] A substantial portion of their taxes on the production of natural gas within their boundaries go into school funds. They say that the "public interest" entrusted to the Commission by 15 U. S. C. § 717 (a) includes the interest of the States where the gas is found. They claim that pricing can be disastrous to the producing States and urge the need for threefold findings by the Commission to ensure an adequate supply of natural gas for future use:

> "First, the Commission must determine the quantity of gas needed to constitute an adequate future supply. Secondly, it must make a conclusion as to the level of exploration and development which will produce the needed gas supply. Finally, it must prescribe a rate which will elicit that level of exploration and development."

They argue that where Commission rates are lower than existing contract rates, continued operation is uneconomical in many so-called "stripper fields":

> "Although daily per well production from these fields is relatively low, their combined remaining recoverable reserves nevertheless constitute a con-

[5] See N. M. Stat. Ann., c. 65 (1953); Tex. Stat. Ann. art. 6004–6066d (1962). In 1935, Texas, New Mexico, Kansas, Oklahoma, Illinois, and Colorado agreed upon an interstate compact for the conservation of oil and gas. Congress subsequently gave its consent to the compact on August 27, 1935, for a period of two years. Pub. R. No. 64, 49 Stat. 939. The compact has been extended by the compacting States, with the consent of Congress, for successive periods without interruption, the latest extension being from September 1, 1967, to September 1, 1969. Pub. L. No. 90–185, 81 Stat. 560.

> siderable percentage of the total reserves for the area which will be forever lost if it becomes necessary to plug and abandon these fields for economic reasons."

The Court of Appeals did not entertain these objections (375 F. 2d, at 18) because it read the *Hope* case as foreclosing them.

Hope, however, did not involve regulation of producers of natural gas, only interstate pipelines. At that time, *Phillips Petroleum Co.* v. *Wisconsin*, 347 U. S. 672, giving the Commission authority over these producers, had not been decided. In *Hope* we assumed that the Act meant what it said in § 1 (b) when it did not extend federal control to the "production or gathering of natural gas." We were not then reviewing a federal order fixing wellhead gas prices for producers. Wellhead gas was not even involved in the *Hope* case. We were concerned there with abuses and overreaching by pipeline companies. We said:

> "If the Commission is to be compelled to let the stockholders of natural gas companies have a feast so that the producing states may receive crumbs from that table, the present Act must be redesigned. Such a project raises questions of policy which go beyond our province." 320 U. S., at 614.

Now that *Phillips* has put the prices of producers under federal control, the interests of the producing States must be considered, appraised, and weighed as an important ingredient of the "public interest." Regulation of wellhead prices by the Commission directly influences the level and feasibility of production, and can significantly affect the producing States' regulation of production. See *Phillips Petroleum Co.* v. *Wisconsin*, *supra*, at 689–690 (dissenting opinion).[6]

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[6] See also H. R. Doc. No. 342, 84th Cong., 2d Sess., p. 2 (1956).

As the Court today says in another context, price in functional terms can be "a tool to encourage" the production of gas. *Ante*, p. ——. The effect of price on the regulatory responsibilities of the several States must therefore be weighed, unless contrary to the mandate of the Act regulation of production is to pass into federal hands.

What the merits may be on this issue we do not know. The matter is complicated. For example, it seems that the revenues of the processing plants are derived primarily (about 80%) from the liquids which they extract from the casinghead gas, rather than from the sale of the residue gas. We do not know how to appraise the chances that this gas would be flared rather than processed if the price were too low. For example, it might be that the processing plants would continue to purchase and process casinghead gas as long as the revenues from the liquids extracted plus those from the residue gas processed exceeded the cost of gathering, processing, and marketing the gas. As long as there is a market for the residue gas remaining after extraction of the liquids, it might be that the processor would sell it at almost any price rather than flare it, in order to recover at least part of his costs. This assumes, of course, that the processor has already made the investment in equipment necessary to purify the residue gas to make it saleable, and that the operating costs of this process are not prohibitive. Conceivably, the price of the residue gas could influence the processing plants in deciding whether to maintain or install the equipment and procedures necessary to make saleable quality residue gas as the liquids are being extracted. We do not know how many processors do not now have that necessary equipment nor the cost of operating and maintaining that equipment.

If the processor is willing to gather and process the gas because of the value of the liquids extracted, it might be that a producer would be willing to sell his casinghead gas rather than flare it, in order to obtain some payment for the gas. On the other hand, the price of the casinghead gas might well be critical for marginal producers, whose revenues from the sale of casinghead gas justify keeping their oil wells in production. But we have no evidence concerning how many oil producers in the Permian Basin area could be termed "marginal."

It may be that the posture of *Hope* was the reason why this phase of the case was not developed. Whatever the reason, it must be developed if the interest of the producing States is not by judicial *fiat* to be subjected entirely to complete federal supremacy, contrary to the promise in the Natural Gas Act.

END OF CASE